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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

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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

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INTRODUCTION

A. Terms of reference, representation and chairmanship[1]

Pursuant to a Recommendation made by the *Special Commission of May 2000 on general affairs and policy of the Hague Conference on Private International Law*, the Secretary General convened a Working Group of experts to examine the possibility of preparing and adopting, through a "fast track" procedure, a new instrument on the question of *the law applicable to the proprietary aspects of dispositions of securities held with an intermediary*.[2]

This Working Group met from 15 – 19 January 2001 in The Hague at the Peace Palace. The meeting was attended by 119 experts from 29 different Member States and 17 international organisations.[3]

The Working Group meeting was opened by Mr Teun Struycken, Chairman of the Netherlands Standing Government Committee for the Codification of Private International Law. He proposed as Chair Mrs Kathryn Sabo (Canada), who was subsequently elected unanimously by the Working Group. During the course of the meeting, a Drafting Group was established. Following a proposal from the Chair, Sir Roy Goode (United Kingdom) was unanimously elected Chairman of the Drafting Group. The Permanent Bureau acted as Reporter.

B. General presentation of the project – an overview[4]

The traditional conflict of laws rule for determining the proprietary aspects of a transfer or pledge of securities is based on the *lex rei sitae* principle (also referred to as the *lex cartae sitae* or the *lex situs* principle). Under this principle, the validity of the disposition is determined by the law of the place where the securities are located. Although easy to apply in the case of bearer securities or directly held securities, this test does not fit well with an indirect holding pattern, *i.e.* where securities are held through one or more intermediaries. Historically, many jurisdictions have attempted to apply this traditional

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1 Given the very specialised nature of the subject matter, the Permanent Bureau sought external advice and asked Mr Richard Potok (of Potok & Co) to act as Legal Expert and to assist the Permanent Bureau to prepare and carry out this project. The Permanent Bureau acknowledges the valuable contribution of Mr Potok in preparing this Report.

2 In its full terms, the Recommendation suggests that the following item be included, with priority, in the Conference's Agenda for future work: "the question of the law applicable to the taking of securities as collateral, it being understood that, without waiting for the Diplomatic Conference, a working group open to all Member States, to experts and associations specialised in the field, should convene to examine, in collaboration with other international organisations, notably UNCITRAL and UNIDROIT, and the private sector, the feasibility of drawing up a new instrument on this topic." See the *Conclusions of the Special Commission of May 2000 on General Affairs and Policy of the Conference*, prepared by the Permanent Bureau, Preliminary Document No 10 of June 2000, for the attention of the Nineteenth Session, pp. 25-26 and 27; these Conclusions are available on the website of the Hague Conference (http://www.hcch.net) under the heading "Work in progress". One may add that the reference to "the law applicable to the *taking of securities as collateral*" is both too broad and too narrow: first, too broad as it might suggest that the proposed Convention extends to *direct* holdings although the project has always been conceived as being limited to *indirectly* held securities; secondly, too narrow as it incorrectly suggests that the proposed Convention may only apply to pledges and title transfer arrangements and not to outright *sales* of securities (for more details, see comments under Art. 1).

3 A full list of participants is attached to the present Report (Appendix A).

4 For a full presentation and analysis of the legal issues involved, see *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 (hereinafter referred to as "Preliminary Document No 1" or "Prel. Doc. No 1"). That Report served as the basic working document at the January meeting and is available on the website of the Hague Conference.

test to indirectly held securities by "looking through" the tiers of intermediaries to the laws of one or more of the following: the jurisdiction of incorporation of the issuer, the location of the issuer's register or the location of the actual underlying securities certificates (the "look-through" approach). However, there are severe conceptual, legal and practical difficulties potentially arising from the application of this approach in the modern context of indirect holding patterns for securities.

Where – as is often the case – a diversified portfolio of securities is provided as collateral, the collateral taker would have to satisfy the laws of the jurisdiction of each issuer, register and/or physical custodian of the securities. In addition, in many jurisdictions it is uncertain exactly what the legal rule is when applying the look-through approach – is it the law of the place of the issuer, the place of the register or the place of the underlying securities? Finally, even if the collateral taker did know the relevant test, often it is not possible to obtain the necessary information to ascertain how to apply the test. For example, a holding through various tiers of intermediaries may not enable the collateral taker to discover where the national central securities depositary actually stores the certificates, if any exist. In some circumstances, the collateral taker may not be able to point to a single jurisdiction, even if it had access to information, where the underlying certificates of a single issue are kept in more than one jurisdiction. For these reasons, the look-through approach is considered by many neither to provide the necessary certainty, nor to be practicable in the modern context.

An alternative approach is to look to the law of the location of the intermediary maintaining the account to which the securities are credited (the "place of the relevant intermediary approach" or "PRIMA"). The major advantage of PRIMA is that the question of whether the collateral taker receives a perfected interest will be governed by the law of one jurisdiction even where a portfolio of securities of issuers from different countries is involved. Furthermore, the application of PRIMA can be seen as an appropriate extension of the *lex rei sitae* principle – the location of the collateral taker's interest in securities credited to a securities account is (and the beneficial ownership of the securities themselves is most likely only recorded) where the securities account is located.[5]

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[5] See also the comments on Art. 3, *infra*, p. 14. – PRIMA has already been statutorily adopted in Belgium, Luxembourg, France, Germany and the United States (see Prel. Doc. No 1, pp. 50-52; for Germany, see the references in Prel. Doc. No 1, footnote 75). It is presently also being considered for enactment in a number of other jurisdictions (including, at least, Australia, Canada, Japan, Bermuda, the British Virgin Islands and the Netherlands Antilles; see Prel. Doc. No 1, pp. 53-54). At a regional level, the *EU Settlement Finality Directive* of 1998 (Directive 98/26/EC of the European Parliament and of the Council of May 1998 on settlement finality in payment and securities settlement systems, OJEC 1998, L 166/45; referred to as the *EU Settlement Finality Directive*) has adopted PRIMA in all EU Member States, although implementation has not been entirely uniform. In some Member States, PRIMA has been adopted only in relation to central banks, the European Central Bank and certain settlement system participants as collateral takers, while in others it has been adopted more broadly to protect commercial counterparties as well (for more details, see IBA/CMF Bulletin No 2 of October 1999). Under the proposed *Directive of the European Parliament and of the Council on financial collateral arrangements* (referred to as the *EU Collateral Directive*), PRIMA is to be applied as a general rule to all situations where securities held through indirect holding systems are provided as collateral (see Art. 10 of the EU Collateral Directive as proposed by the European Commission on 27 March 2001, COM(2001) 168 final, 2001/0086 (COD); formerly Art. 11 of the Working Document on Collateral from the Commission to relevant bodies for consultation, First Preliminary Draft Proposal for a Directive, Document number C4/PN D(2000), dated 15 June 2000).

C. Results of the meeting

At the outset, it should be mentioned that the experts unanimously agreed that ***the Hague Conference could and indeed should prepare, on an accelerated timetable, a Convention on the law applicable to proprietary aspects of dealings in securities held through indirect holding systems***.

The Working Group, however, went further than merely considering the feasibility of the project and, after having had the opportunity to examine the major issues of substance raised, drew up a *tentative text of the key provisions for a future draft Convention* (Work. Doc. No 16 of the January meeting, reproduced as Appendix B to the present Report; hereinafter referred to as the January draft). This tentative text was prepared by the Drafting Group and discussed by the plenary session during the final day of the meeting. In order to reflect the results of the final day's discussion, the Permanent Bureau, together with the Legal Expert to the Permanent Bureau and the Chair of the Drafting Group, prepared and distributed in February 2001 an amended tentative draft text for further consideration (hereinafter referred to as the February draft).

Both the January and February drafts reflect the *experts' unanimous support for PRIMA as the appropriate connecting factor to be included in the future convention*; no support was given by any of the experts at any point to the look-through approach. The adoption of PRIMA was seen by a number of delegates as the natural extension of the *lex rei sitae* principle to indirectly held securities.[6]

D. Prior and subsequent informal work

Given the tight agenda suggested by the Member States for this project and the need to act on the basis of a "fast track" procedure if the goal of adopting a Convention during 2002 is to be achieved,[7] the Permanent Bureau organised prior to the January meeting a series of three telephone conference calls with 30-50 participating experts. The aim of these conference calls was to identify the main issues to be tackled by the Working Group and to propose possible answers.[8] The calls were in general found to be extremely beneficial and effective in preparing for the January meeting.

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[6] See *infra*, p. 14.

[7] The main reason for aiming to reach early agreement on the text of the suggested Convention is the tremendous practical importance of the underlying issue. The last decade has seen a sharp increase in the number of collateralised arrangements within the financial services industry, particularly those involving a cross-border element. The exposures involved are extremely large – each day hundreds of billions of dollars of securities are provided as collateral under arrangements involving a cross-border element, and the market is growing rapidly. Collateral providers are able to reduce their borrowing costs if collateral takers are willing to accept securities held by the collateral provider as collateral. Collateral takers, however, need to be certain that they have an interest in the securities that is enforceable against the collateral provider and as against third parties (*i.e.* a perfected interest). Today's market reality does not provide this certainty: in many jurisdictions, existing conflict of laws rules with respect to proprietary issues, such as perfection and priorities of competing securities interests, are by no means clear. In fact, in some jurisdictions multiple answers are possible, which results in a collateral taker needing to perfect in a number of jurisdictions. The "fast track" procedure has been suggested to overcome these difficulties quickly with a view to clarifying the position for the benefit of the market.

[8] For the first call, the Permanent Bureau invited experts who had contributed to Prel. Doc. No 1 or who had been involved in the replies to the questionnaire contained in Working Document No 1. The second and third conference calls were open to all delegates who had been officially designated by their respective governments or organisations by the day before the conference call. A fourth call on 20 April 2001 (see the following comments in main text) was open to all experts who had attended the January meeting, with a number of additional experts joining.

Similarly, after the January meeting, the Permanent Bureau continued to discuss with legal experts on an unofficial basis the tentative text prepared in January and to work closely with market participants to ensure that the future convention incorporates a solution which is both practicable and provides the required level of certainty. A fourth conference call was held on 20 April 2001 in order to discuss the numerous comments on the February draft and new suggestions submitted by a large number of experts. Around 45 experts from 15 different States participated in this fourth call.

The vast majority of delegations has been very supportive of the informal working process, taking into account in particular that the various conference calls provided a forum in which to identify and – where necessary – to clarify potential concerns and to explore possible solutions. Other delegations, however, have indicated some concerns about a possible lack of transparency of the informal working process and their difficulty to involve a representative group of experts in this process. In this regard, it has to be stressed unequivocally that no decisions have been taken during or after the conference calls and that all the issues discussed during these calls were subject to a full review during the January meeting – and indeed remain subject to further consideration at any future meeting. Considering the upcoming decision on the future agenda to be adopted for this project,[9] it is suggested that the informal process should continue going forward, subject to the same strict conditions of transparency applied until now.

In this Report, we shall try to provide a first brief commentary on the key provisions drafted during the January meeting. Where appropriate, reference will be made to the informal work conducted prior to and following the January meeting.

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[9] The future agenda for this project will be examined by the *Commission on General Affairs and Policy of the Conference*, which will meet during Part I of the 19th Diplomatic Session of the Hague Conference on Private International Law, scheduled for 6-22 June 2001.

BRIEF COMMENTARY ON THE TENTATIVE TEXT FOR A DRAFT CONVENTION PREPARED AT THE MEETING AND RESULTS OF THE INFORMAL WORK CONDUCTED PRIOR TO AND AFTER THE MEETING

ARTICLE 1: SCOPE OF THE CONVENTION

This provision has two basic purposes: while paragraph 1 describes in broad terms the *substantive* scope of application of the proposed Convention, paragraph 2 addresses its *geographic* scope.

A. Substantive scope (paragraph 1)

(a) Matters covered

Article 1, paragraph 1, is drafted in rather broad terms and refers to ***"proprietary aspects"*** in general, without defining the content of these proprietary aspects. Such introductory provisions are quite common in existing treaties and may indeed be found in most of the modern Hague Conventions.[10] Their apparent lack of precision should not be over-emphasised: these provisions are merely describing the broad "legal field" to which the Convention applies. Article 1, paragraph 1, has to be read in conjunction with Article 5, which contains a detailed list of the specific issues addressed by the Convention.[11] During the January meeting and the subsequent informal work, several experts have suggested that Article 1 should explicitly refer to Article 5 in order to ensure clarity and consistency.[12]

Even without an explicit cross-reference to Article 5, the broad term "proprietary aspects" in Article 1 remains very useful, as it clearly indicates that ***the Convention does* not *apply to the contractual aspects of transactions***. As already indicated in Preliminary Document No 1, there are always two components to a collateral transaction or transfer of property that need to be distinguished: first, the contractual element, describing the parties' obligations under the transaction and, secondly, the proprietary element, dealing with the actual transfer of rights in the property. The proposed Convention only deals with the latter, *i.e.* the *identification of the appropriate law to govern proprietary aspects of a disposition of indirectly held securities*.[13]

The contractual aspects of an agreement under which such a disposition is made are covered by separate conflict of laws rules. These rules are usually clear and allow the parties to choose the applicable law. Within the context of transactions in respect of indirectly held securities, these rules do not create specific problems which would need to be addressed in the proposed Convention. This clear distinction between proprietary and

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[10] A particularly striking example is provided by Art. 1 of the *Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition,* which solely states that the Convention "specifies the law applicable to trusts and governs their recognition." The term "trust", the necessary characteristics of a trust, and the scope of the law applicable, are specified and explained in the subsequent provisions of the Convention.

[11] In the January Draft, Art. 1, para. 1, contained the word "the" before the reference to "proprietary aspects". The deletion of the word "the" in the February draft was intended to address one delegation's concern that this provision might be read as conflicting with the formulation in Art. 5.

[12] In view of the mere introductory nature of this provision, one may wonder, however, whether a clear statement in the official *Explanatory Report* to the Convention would not suffice to meet the need for clarity.

[13] Prel. Doc. No 1, p. 4.

contractual elements already appears in previous Hague Conventions: the *Convention of 1958 on the law governing transfer of title in international sales of goods* was indeed negotiated as an instrument distinct from the *Convention of 1955 on the law applicable to international sales transactions*.[14]

In addition, it may be noted that the reference to "dealings" confines the proposed Convention to *consensual* transactions as opposed to rights arising by *operation of law*.[15] Finally, the provision specifies that the Convention only applies to *indirect holding systems*, excluding from its scope *direct holdings*.[16]

(b) Matters not covered

Even on the basis of this broad description, it is apparent that the Convention does *not* apply to: (a) the contractual rights and obligations of parties to a transaction in securities (see comments above); (b) the contractual rights and obligations of an intermediary and an account holder; (c) the rights and duties of an issuer of securities (including the right to registration with an issuer, voting rights, rights to receive dividends, etc. – all these matters are classic *lex societatis* issues); (d) the rights and duties of a registrar acting for the issuer; (e) the regulation of the issue or trading of securities; or (f) the regulation of a securities intermediary.

For reasons of clarity and predictability, some experts have suggested during the informal work conducted after the January meeting that the matters to which the Convention does *not* apply should be expressly identified (either in Art. 1 or in a new Art. 2). Other experts have stressed that such a list of exclusion could not be exhaustive and would have to be inserted by way of illustration only.

In this regard, it has to be emphasised that ***the proposed Convention neither interferes with the nature of an investor's interest in the indirectly held securities, nor imposes any change on a State's substantive law in this regard***. 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. As explained in Preliminary Document No 1, the nature of an investor's interest in securities held through indirect holding systems varies among different legal systems and jurisdictions. Basically, these interests can be *proprietary* or *contractual*, and, if proprietary, may take one of a number of forms, for example, some kind of co-ownership interest or a new kind of legal interest not involving co-ownership.[17]

The proposed Convention, however, is based on two fundamental propositions: first, that the identification of the appropriate law to govern proprietary aspects of a disposition of indirectly held securities can be conducted without affecting a State's substantive law, and, secondly, that the conflict of laws rule eventually adopted should apply rationally and consistently to an investor's interest

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[14] Texts available on the website of the Hague Conference, in French only.

[15] See, however, *infra*, p. 14. (Art. 2, para. 3)

[16] For a detailed presentation of the indirect holding system, see Prel. Doc. No 1, pp. 12-18; for a discussion of a specific holding pattern which is rather common in Nordic countries, see *infra* p. 11.

[17] Another possibility is that the *lex societatis* recognises, in situations where securities are held through intermediaries, that the records of the relevant intermediary, *i.e.* the investor's immediate intermediary, are the means by which transfers and other dispositions of the underlying securities are effected. While under such a structure the legal nature of the property is not affected, it would still seem to be appropriate to treat the law of the place of the intermediary as the law governing proprietary aspects. For a detailed presentation of the various systems, see Prel. Doc. No 1, p. 5, pp. 19 *et seq.*, pp. 23 *et seq.*, and p. 54. As mentioned in Prel. Doc. No 1, p. 26, harmonising the substantive law relating to the nature of interests in respect of securities held through intermediaries is a major undertaking that may be considered by UNCITRAL or UNIDROIT in the near future.

irrespective of the form the interest takes. Thus, the proposed Hague Convention will take a similar approach to the one taken by the *EU Settlement Finality Directive*.[18] This Directive has not introduced a uniform categorisation of the legal nature of an investor's interest in securities held through an indirect holding system; it has, however, introduced a provision intended to clarify the conflict of laws when such securities are taken as collateral.[19]

B. Geographic scope (paragraph 2)

Article 1, paragraph 2, addresses the geographic scope of the Convention. Its main objective is to ensure that the Convention does not apply to purely internal situations. At the January meeting, the Drafting Group proposed two variants. According to the first variant, the Convention would not have applied "where all the relevant factual elements of the situation are located in one State". At the plenary session, however, the concern was raised that the first variant appeared to be circular, as it did not specify which factors would have to be considered as "relevant". Hence, it was decided not to retain this proposal.

The Permanent Bureau, therefore, proposed an alternative formulation along the lines in the second variant, *i.e.* drafting a provision that would define the geographic scope of application of the Convention by referring explicitly to the location of the account, the parties or the issuer. It became clear, however, that it may be difficult to achieve wording which is both precise and exhaustive so as to be appropriate under all circumstances. On reflection, the Permanent Bureau suggested replacing both previous variants with one generally-phrased affirmative variant which reflects similar formulations in other existing Conventions –– for example, the *Hague Convention of 1986 on the Law Applicable to Contracts for the International Sale of Goods* (Art. 1, lit. b) and the *Rome Convention of 1980 on the Law Applicable to Contractual Obligations* (Art. 1, para. 1).

Under the proposed language, the Convention should first apply if any of the account holder, the lender/purchaser or the relevant intermediary (*i.e.* the securities account) are in different countries. The issue then arises, however, of situations of the type where the investor, the lender/purchaser 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). This fact pattern was expressly discussed during the January meeting. There was consensus that the Convention should also apply in such a case, as otherwise there would be a risk of applying the "look-through" approach. Finally, the Convention should also apply if any of the intermediaries through whom the securities are held is located in another State.

During the informal work conducted after the January meeting, some experts suggested that the specific situations in which the Convention applies be spelled out in Article 1, paragraph 2, with a view to enhancing clarity and predictability. It may indeed be helpful to add at the end of Article 1, paragraph 2, of the February draft (or in a new paragraph), language such as: "It applies in particular if any two of the following are located in different States: (a) the relevant intermediary; (b) the issuer or issuers of the securities; (c) the account holder; (d) any party to a disposition of the securities; or (e) any securities intermediary through whom the securities are held."

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[18] See the references in footnote 5.

[19] See Prel. Doc. No 1, p. 48.

ARTICLE 2: INTERPRETATION

This provision contains a set of definitions and descriptions of some of the key concepts used in the Convention.

A. Definition of "securities"

In theory, there appear to be three possible approaches to defining or describing the term "securities" in the proposed Convention:

Variant 1: by providing an *explicit definition or a detailed enumeration* of securities (the "fully fledged" approach);[20]

Variant 2: by providing a *general description* of securities, with or without an illustrative list of the most important examples (the "descriptive" approach);[21] or

Variant 3: by leaving the definition to *national law* (the "domestic law" approach), *i.e.* either to:

Variant 3a: the *lex fori,* or

Variant 3b: the *lex causae.*

(a) The discussions prior to the January meeting

All three options had already been examined by the experts during one of the conference calls prior to the meeting. During this call, the experts acknowledged that the *fully fledged approach* could result in a very precise description of the Convention's scope of application, enhance certainty and hence facilitate uniform interpretation. However, the experts were also at one in stressing that national characteristics would make consensus on a detailed definition and/or enumeration not only very difficult to reach, but also complex and time-consuming to draft. Most importantly, it was underlined that such a method might run counter to the need for sufficient flexibility to accommodate new types of securities. Finally, it was also mentioned that even in the case of a detailed definition or enumeration such as the one contained in the *Securities Act of Ontario*, a much more general "fall-back" provision referring to "a document commonly known as a security" seemed to be inevitable. Given these major difficulties, the fully fledged approach was not regarded by the experts as a suitable solution for the proposed Convention.

As regards the *descriptive approach*, there was consensus that this approach may be both explicit enough to provide sufficient guidance for a uniform application of the proposed Convention (especially if an *illustrative list* of examples of typical securities was included), and flexible enough to take into account new types of securities. In addition, it was stressed that a provision based on this approach should not be too difficult to draft. Although it was mentioned that this approach would leave scope for some unevenness in the implementation of the proposed Convention, it was recognised that this risk seemed to be relatively small, as there is broad consensus on what is in general meant by "securities." The descriptive approach, therefore, had significant support from the experts.

As regards the *domestic law approach*, the experts acknowledged that a reference to the *lex fori* would have the advantage that this is the law the practitioners and courts are

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[20] See the *first approach* mentioned in Prel. Doc. No 1, p. 43. An example of this approach is provided by Chapter S.5 of the Securities Act 1990 of Ontario (revised Statutes).

[21] This approach corresponds to the *second approach* mentioned in Prel. Doc. No 1, p. 43.

most familiar with and that such an approach would be very easy to draft. On the other hand, it was also recognised that a reference to the *lex fori* leaves scope for some unevenness in the implementation of the proposed Convention, that it may run counter to the need for sufficient flexibility to accommodate new types of securities, and, most importantly, that there might be potential conflicts between the *lex fori* and the *lex causae* (PRIMA). For all these reasons, the *lex fori* approach was not supported by the experts.

As regards the *lex causae* approach, the experts first stressed that it would be very easy to draft. In addition, this approach would have the advantage that the same law would govern the definition of both the securities and the proprietary aspects of the transaction. In other words, only one law would need to be considered for both purposes. As a result of the discussion, there emerged an approach under which the term "securities" would simply be linked to what is eligible for deposit or may be evidenced by credit to a securities account. This approach may be viewed as a development of the *lex causae* approach, because the ultimate question as to whether or not a particular instrument is actually eligible for deposit will have to be answered by the law of the place of the account, *i.e.* the *lex causae*.

(b) The January meeting

Based on the results of the informal discussion during the conference calls, there was prompt consensus among the experts that it was no longer worthwhile to consider either variant 1 (fully fledged approach) or variant 3a (*lex fori* approach). The discussion thus focused on the *lex causae* approach and the descriptive approach. Several experts held that the definition or description embodied in the future Convention ought to be *as broad and as simple as possible* and provide enough *flexibility* for future instruments. This was regarded by the Working Group to be the main and fundamental objective of the definition. The actual result of the discussion is reflected in Article 2 of Working Document No 16, as amended by the February draft.[22]

The language suggested in Article 2 seems to meet the needs of a broad, simple and flexible definition of "securities". The concept is similar to the approach adopted in the US (*Uniform Commercial Code*) and the EU (*Investment Securities Directive* and the *proposed EU Collateral Directive*).[23] The structure of the definition is traditional: it refers to a broader term, *i.e.* "financial asset or instrument", and then uses a specific criterion, *i.e.* the "capability of being credited to a securities account" to differentiate the subject matter.[24] The words "or any interest therein" are designed to take into account the fact that in many systems, book entries represent a mere interest *in* securities, not the *securities themselves* (this latter solution applies, for example, in France with its fully dematerialised securities regime). The provision also contains an *illustrative list* of securities, which explicitly mentions the most common and important types of securities,

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[22] The suggested amendments appearing in the February draft are minor: the specific examples mentioned in the definition were amended to the plural (which seems appropriate given that the defined term is itself in the plural) and the words "with a securities intermediary" were deleted, because they are included in the definition of "securities account".

[23] See Prel. Doc. No 1, pp. 43-44.

[24] During the informal work undertaken after the January meeting, two delegations suggested that the definition be slightly amended so as to reflect that the securities must actually "have been credited" to a securities account (rather than just reflecting that the securities "may be" credited to an account). This proposal appears to be appropriate, as the parties will only be able to dispose of securities that are already credited to an account.

i.e. stocks, shares and bonds (whether convertible or not). One of the attractions of the suggested definition is that it seems flexible enough to account for classes of instruments moving from one category to the other as the market develops. But what does the proposed definition mean in practical terms?

At the outset, it should be noted that the suggested language encompasses both *certificated* and *dematerialised* securities, whether such securities are *listed* on an exchange or not. The provision does not expressly address the position of *derivative instruments*. Since at least the great majority of derivatives are likely to constitute "financial assets or instruments", the factor determining whether or not a particular derivative is covered will be whether it is "capable of being credited to a securities account". It is clear that the draft Convention contemplates an account of the conventional type, the balance of which will fluctuate over time as a result of debits and credits made to the account. This implies that instruments credited to such an account must be sufficiently standardised in their terms as to be fungible, since new instruments credited to such an account become indistinguishable from those already credited to it. Some instruments of a kind often referred to as derivatives – for example *subscription warrants* or *"covered" warrants* conferring the right to buy specified securities – clearly fall within this 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. It is the collateral that supports the swap that is credited to an account and, if in the form of indirectly held securities, is the item to which the Convention applies. Finally, it would appear that *physical commodities* and instruments representing physical commodities (such as *metal warrants* and *bills of lading*) are excluded from the scope of the proposed Convention. These instruments are not fungible: separate consignments of metal are clearly distinguishable from each other. In other words, if individual entries in respect of separate consignments of metal had to appear on the books of an accounting system, a series of *separate* accounts would have to be opened. For similar reasons, a mortgage over real property ("*hypothèques*") would also clearly fall outside the scope of the definition.

What is the impact of the suggested language on ***cash***? During the January 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 international central securities depositaries (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 proposed Hague Convention might be an overreaction. 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.

B. Definition of "securities intermediary"

The question of the definition of a "securities intermediary" had not been specifically addressed during the informal discussions prior to the January meeting. As regards the definition suggested by the Drafting Group, it is important to note that it does not only

include *central banks* and *national and international central securities depositories*, but that it also encompasses *any person who maintains accounts for others to which securities are credited*.[25] The term of *"person"* should be given its ordinary meaning; it thus not only includes legal persons, but also natural persons,[26] unincorporated firms and partnerships. The suggested definition is not tied to regulatory requirements (such as rules relating to supervision). The experts agreed that this was a matter of substantive public law of the jurisdiction concerned.

The qualification expressed by the words "acting in that capacity" is designed to exclude from the definition issuers who are not acting as an intermediary; the definition does, however, encompass the frequent cases where an issuer is at the same time an intermediary for its own securities (*e.g.* a large bank which issues shares and holds them on its book for its clients). On the other hand, one may wonder whether the current wording perfectly fits with some specific holding patterns. One holding pattern which may require further assessment in this respect is rather frequent in the *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 owner, 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 individual owner'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" for purposes of the proposed Convention.

The current wording of the definition is couched in general terms. There is, as already mentioned, no reference to the fact that a securities intermediary has to be subject to *regulatory requirements* in order to qualify for the definition. These requirements vary from one jurisdiction to another and the proposed Convention is not designed to establish a uniform standard for such requirements. As a result, the definition is silent on regulatory requirements and they are left to national law. The wording is also general in that it potentially refers to any securities intermediary; in other words, the definition does not contain a reference to what is the "relevant" intermediary. It seems obvious, however, that in an individual case the definition will point to the securities intermediary that has actually *agreed with* the account holder to maintain the securities account.[27] In

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[25] In subsequent informal discussions, it has been suggested that the reference should be amended so as to ensure that the Convention does not apply to cover the register maintained by or on behalf of the issuer itself in respect of registered securities.

[26] This of course does not mean that the Convention requires a Contracting State to allow a natural person to act as a securities intermediary. In several countries (such as Luxembourg), it is indeed not permitted for a natural person to act as a securities intermediary. The Convention's definition merely ensures that where natural persons, unincorporated firms and partnerships are allowed to act as securities intermediaries, the Convention may be applicable.

[27] We deliberately use the neutral expression "agreed with" rather than the technical term "contracted with". The latter expression might indeed create problems when the investor deals with a multi-national corporation's branch that has no contractual powers to actually sign and enter into any agreement with the investor. In such a case, the contract will presumably have to be signed by headquarter executives, who may be located in a jurisdiction with which the investor has no contact at all and whose law, therefore, should not apply to the proprietary aspects of the investor's transaction with a lender/purchaser. Not only may this law come as a surprise to the investor and its counterparty, it may not even be regarded as any longer a proper reflection of the *lex rei sitae* principle. See also *infra*, p. 23.

order to avoid any misunderstanding and to further enhance legal certainty, one delegation has suggested after the January meeting to add a specific definition on this issue to Article 2.

C. Definition of "securities account", "account right" and "account holder"

(a) "securities account"

The definition of a "securities account" establishes that this is an account with a securities intermediary to which one or more securities are credited. In practical terms, one has to note that what is being credited to a securities account is the *number and nominal amount* of securities held by the account holder, rather than the current market value of these securities.

(b) "account right"

Two principal comments have been made in relation to this definition. First, some experts were concerned that it be made clear, if necessary by additional wording, that the Convention covers dispositions in respect of a securities account as a whole and not merely securities or interests in securities credited to a securities account. Secondly, some experts were concerned that the use of the phrase "aggregate of the rights" within this definition would import into the proposed Convention issues relating to *contractual* rights, which would not be appropriate for a Convention confined to proprietary matters. In the light of these comments, it is for further consideration whether the definition of "account right" should be amended. Alternatively, consideration might be given to omitting the defined term and instead amending the text of the operative provisions and using a phrase such as "indirectly held securities" which could be defined to include, securities and interests in securities credited to a securities account.

(c) "account holder"

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

D. "Disposition"

The use of the word "disposition" is intended to give the Convention a *broad* scope of application in the sense that the latter 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 can be part of 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.

As regards *collateral transactions*, one has to note that in today's economy there are numerous ways of raising money and obtaining protection against credit exposure. Not all the ways of obtaining such protection operate through the *pledge* mechanism (for which the tentative draft contains a specific definition, see *infra*, under E): some use a *title transfer* mechanism, under which ownership of the collateral is transferred outright to the

collateral taker, who only has a contractual obligation to redeliver equivalent securities. These title transfer mechanisms fall under the expression "outright transfer of title", for which there is no specific definition in the Convention (contrary to the reference to "pledge"). 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. Such "title transfer mechanisms", however, form only *one part* of the transactions which lead to an outright transfer of title. The other part, obviously, is formed by *sales*. It is true that, in practice, the most significant issues tend to arise in relation to collateral transactions. However, for the purpose of determining the applicable law, there is no reason to distinguish *collateral transactions* from *sales*. Hence, the conflict of laws rule embodied in the Convention applies to *both* these categories. Some experts have suggested that this two-fold character of the Convention would be more adequately expressed if the reference to "outright" transfers were deleted. Other experts have emphasised the desirability of avoiding a formulation which could provide support for arguments that a transfer of title ought to be "recharacterised" as a *pledge* by reference to its economic purpose or effect.

E. "Pledge"

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, which are expressly referred to).[28] Some experts have suggested that this be made explicit in the definition. Under a pledge, the collateral provider retains ownership of the securities pledged.

F. "Perfection"

The only concern expressed with regard to the proposed definition is that it is limited to *third parties;* this could possibly lead to the application of a law other than PRIMA where only the parties to the transaction are involved (such as in the case of an outright sale).[29] In substance, there is no doubt that the same law (PRIMA) should apply to both outright sales and any form of collateral transactions.

G. "Insolvency proceedings" and "insolvency administrator"

The proposed definitions of these terms are identical to Article 5 letters (e) and (f) of the *UNCITRAL Draft Convention on assignment of receivables in international trade*. Both these definitions include reorganisation procedures. At first sight, they appear to be broad enough to cover different kinds of insolvency proceedings, irrespective of (i) the

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[28] See Prel. Doc. No 1, p. 6. As already mentioned in Prel. Doc. No 1, it is fully recognised that the term "pledge" was originally limited to *possessory* interests in physical property only. Because of the potential confusion surrounding the expression "security interest" in an international (and multi-lingual) context, it seems nevertheless preferable to use the term "pledge" and to deliberately extend its traditional meaning so as to cover non-possessory interests as well.

[29] The definition of "perfection" has been moved from the old Art. 5, sub-para. (c) of the January draft because the term is used in Art. 9 (International mandatory rules). No change of substance has been made.

debtor, (ii) on which grounds the proceedings may be opened and (iii) whether the proceedings are voluntary or involuntary.

H. Article 2, paragraph 2

This paragraph did not appear in the initial January draft. It has been added to the February draft with a view to clearly indicating that the Convention applies equally to a *partial* disposition of an account holder's rights. This was not thought to be a change of substance, but to be a mere clarification, given the definition of "account right" as the aggregate of the rights represented by the credit of securities to a securities account. Making this change appeared less cumbersome than adding references to "any interest in an account right" throughout the substantive provisions of the Convention.[30]

I. Article 2, paragraph 3

The basic purpose of this paragraph, which was included in the February draft, is to ensure that a disposition of an account right includes a disposition to or in favour of the account holder's own securities intermediary. During the course of the informal work undertaken subsequent to the presentation of the February draft, one delegation suggested that this paragraph be amended so as to include *transfers by operation of* law, such as liens arising during the clearing and settlement process. Others questioned this proposal, stressing that the conflict of laws principles applicable to transfers by operation of law might be different from those applicable to dispositions *inter partes*. This will have to be clarified in the further negotiation process.

ARTICLE 3: DETERMINATION OF THE APPLICABLE LAW

A. General comments

Article 3 is a key provision because it incorporates PRIMA into the Convention. As already mentioned, the experts unanimously supported PRIMA as the appropriate connecting factor to be included in the future Convention, and no support was given to the "look-through" approach.[31]

PRIMA reflects the reality of the indirect holding system and follows the sound legal principle that the law applicable to proprietary matters should be the law of the place where the record of title is maintained and where, therefore, orders in respect of the property can be *effectively enforced*. In indirect holding systems, the record of an investor's title is maintained by the intermediary with whom the investor has an immediate relationship and any disposition of the investor's interest in favour of a collateral taker or purchaser will therefore appear on the books of the investor's immediate intermediary. This suggests an approach that looks to the law of the place where that intermediary is located.

Against this background, PRIMA may legitimately be regarded as an updated application of the traditional *lex rei sitae principle*.[32] This applies even to situations where certificates have been issued and are kept in the CSD's vault located in a different jurisdiction to that of the intermediary. It is true that in such a situation, one might argue that the physical

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[30] If references to "account rights" were deleted from the Convention (see the comments *supra*, p. 12), Art. 1, para. 2, would have to be removed altogether.

[31] See *supra*, p. 3.

[32] The *lex rei sitae* principle can be traced back to the work of the *statutists*, *more precisely* to *Aldricus* (late 12th/beginning 13th century) and, in particular, to *Bartolus* (13th/14th century); the principle was later confirmed by Savigny (19th century).

location of the certificates determines the *lex rei sitae*. Such a deduction, however, can legitimately be challenged by reference to the ultimate justification of the *lex rei sitae* principle, *i.e.* the application of the law of the place where orders in respect of the property can be *effectively enforced*. Within an indirect holding structure, this place can only be the *place of the relevant intermediary, i.e. the place of the account* (see *infra* comments on Art. 4), not the place of the location of the physical certificates, where the investor is not even known and the transaction not recorded or reported.[33]

Finally, as regards the draft language of Article 3, one may add that the reference to "proprietary aspects" has been incorporated into the February draft with a view to ensuring conformity with Articles 1 and 5. This is not intended to be a change of substance.

B. Fact pattern involving several intermediaries

Article 3 is drafted in rather general terms in the sense that it refers to the *relevant* securities intermediary without actually defining or indicating who is to be regarded as the *relevant* intermediary. It has already been mentioned that in an individual case, the definition will point to the securities intermediary that has agreed with the account holder to maintain the securities account.[34] In order to avoid any misunderstanding and enhance certainty, one delegation suggested during the informal working process after the January meeting that a specific definition on the *relevant* intermediary be added to Article 2.[35]

At the January meeting and during the informal working process subsequent to it, several experts stressed that the Convention should specifically address the situation where several intermediaries are involved in a transaction. In these situations, it is indeed not obvious who has to be regarded as the *relevant* intermediary. This applies in particular to the situation where the collateral provider and the collateral taker hold through different intermediaries and the collateral is provided by way of title transfer.[36] Under such a holding pattern, the collateral provider's (seller's) interest is not transferred *directly* to the collateral taker (purchaser), since the collateral provider (seller) never holds an interest with the same intermediary as the collateral taker (purchaser). Instead, the collateral provider (seller) instructs its intermediary to transfer interests to the collateral taker's (purchaser's) intermediary, with a request to the latter to credit the collateral taker's (purchaser's) account.

In Preliminary Document No 1, we suggested that under PRIMA the proprietary aspects of each of the three stages of this transfer process should be governed by a *different law.*[37] Against this background, *the decisive question as to whether the transferee (collateral taker/purchaser) acquires a valid interest is subject to the law of its own intermediary*. This seems appropriate as the securities are ultimately credited on the books of the transferee's intermediary.

During the January meeting, however, one delegation questioned whether the principle of using multiple connecting factors for the transfer process would indeed be appropriate. This delegation stressed that there might be a disharmony between the various laws involved: there is in particular the question as to what would happen if the law of the

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33 See Prel. Doc. No 1, pp. 27 *et seq*.

34 See footnote 27 and accompanying text.

35 See *supra*, p. 11.

36 The experts involved in the negotiation process commonly refer to this fact pattern as the "page 37 problem", for this is where the question is analysed in Prel. Doc. No 1.

37 See Prel. Doc. No 1, pp. 37-38.

collateral provider's (seller's) intermediary would regard the transfer of title as invalid, whereas the same transfer would be regarded as valid by the collateral taker's (purchaser's) intermediary? The solution suggested in the Preliminary Document is to *differentiate among the various elements of the transaction*; such an approach would presumably lead to the following solution in the case mentioned:

Whether the collateral provider's (seller's) interest in its intermediary's pool of customer securities is validly extinguished is a matter of the law of this intermediary; whether the appropriate proportion of this intermediary's interest in the higher-placed intermediary's pool of participants' securities is validly transferred to the collateral taker's (purchaser's) intermediary is a matter of the law of the place of the higher-placed intermediary; finally, whether the collateral taker (purchaser) acquires a valid interest in its intermediary's pool of customer securities is a matter of this intermediary's law. However, whether any defect under the law of the collateral provider's (seller's) intermediary will flow through so as to impair or invalidate the second element of the transaction will be a matter of the law of the higher-placed intermediary. Likewise, whether any defect under the law of the higher-placed intermediary (including, if applicable, a defect arising because that law recognises a defect in the first element of the transaction under the first intermediary's law as infecting the second element) will flow through so as to impair or invalidate the third element will be a matter of the collateral taker's (purchaser's) intermediary.

Obviously, experts may have a different opinion on this particular issue and further discussion is undoubtedly needed. As a matter of fact, during the informal working process after the January meeting, several other experts have also stressed the importance of this particular issue, which will have to be addressed in due course.

Once the *relevant* intermediary has been identified, one still has to determine where this intermediary is actually located for purposes of PRIMA. This cardinal question is dealt with in Article 4 of the proposed draft.

ARTICLE 4: DETERMINATION OF THE PLACE OF THE RELEVANT SECURITIES INTERMEDIARY

INTRODUCTION

Much of the discussion during the January meeting related to the question of how to locate the relevant intermediary. In fact, this question rapidly turned out to be the authentic *pièce de résistance* of the meeting and of the subsequent informal discussions.[38] The crucial role of this question is hardly surprising and indeed had to be expected, as the determination of the intermediary's actual location will eventually put the PRIMA concept in a concrete form and lead to the designation of the law applicable. The problem of how to locate the intermediary is therefore at the very heart of the project. The discussion during the meeting showed that several aspects need to be distinguished. These aspects will be addressed separately in the following comments.

[38] Most of the informal work conducted prior to the January meeting had already focused on this single issue.

A. The principles agreed upon

(a) "Place of the relevant intermediary" = "place where the securities account is maintained"

First, the experts agreed that the localisation of the relevant securities intermediary should be linked to the place of the *account* to which the securities are credited. It is indeed on the *account* that the collateral taker's or transferee's interest will be recorded and where this interest may therefore eventually be enforced. As the ultimate place to look at is the place of the account, some experts suggested that the reference in Article 3 to the place of the relevant securities intermediary should be deleted and replaced by an explicit reference to the place of the securities account. While this might be perceived as a welcome simplification, focusing directly on the rationale underlying the main issue of the Convention, one may equally wonder if the deletion of the only express reference to PRIMA would not introduce an element of uncertainty and cause experts and practitioners to hesitate as to which approach has actually been taken in the Convention. PRIMA has become so widely accepted that experts and practitioners will presumably look for an explicit reference to it in the Convention itself. Against this background, the deletion of Article 3 may turn out to be counter-productive and the "two stage approach" may well be acceptable, subject of course to clear definitions of the terms "securities intermediary" and "securities account". Perhaps the matter can be resolved by a small change in drafting technique to clarify that the concept of the place of the relevant securities intermediary means the place of the particular office of the securities intermediary identified under the Article 4 test.

(b) Ex ante *certainty*

Secondly, there was consensus among the experts on the need for *ex ante* certainty, *i.e.* the need for the parties to a transaction to be in a position to establish *beforehand* where the account is being maintained. 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.[39] Initially, there was however no full agreement among the experts on how to achieve this goal. Some delegations wanted the test to be the jurisdiction of the *law chosen by the parties to the custody agreement* or of the place specified by the parties to the custody agreement as the location of the account; along with this principle, one delegation stressed that the ability to designate the law applicable should not be subject to any requirement for a connection between the place designated in the agreement and the other facts of the transaction. Other delegations, however, explained that they could not accept a test that would allow parties freely to choose the law applicable to the proprietary aspects of a transaction and to invoke this choice against third parties. As a matter of fact, it is worth noting that although some civil law jurisdictions allow for *party autonomy* to apply to the proprietary aspects of a transaction, none of these jurisdictions seems to allow for this choice to be invoked against third parties.

Against this argument, it was pointed out that in the present context use of the term "party autonomy" was not appropriate, as it could imply that the parties to the *collateral transaction* or *sale* could determine by agreement the law governing the proprietary aspects of the transaction. This, however, had never been suggested, not even in the domestic legislation of those jurisdictions which were in favour of a test leading to the

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[39] On this issue, see also *infra*, p. 20.

application of the law chosen or of the place specified by the parties to the custody agreement.[40] Against this background, it would appear that it is ***not appropriate to refer to the concept of "party autonomy" in the context of the proposed Article 4.*** Under this provision, the parties who are designating the law applicable by localising the account are the *investor* (account holder) and its *intermediary*. Under the concept of party autonomy, however, it would be the *investor* and the *collateral taker* or *transferee* who would be offered the possibility to choose the law applicable to the various aspects of their transaction. Such a choice, however, is not what is being suggested in Article 4: this provision simply offers to the investor and its intermediary the possibility of *localising their account*.[41] It has to be stressed though that such a localisation does of course have a "reflex effect" (*effet réflexe*) on the actual transaction concluded between the investor and the collateral taker or transferee, as it is the law that would be governing the proprietary aspects of this transaction. But to refer to it under the heading of "party autonomy" would be misleading. ***In order to avoid further misunderstandings, it is suggested that the proposed solution be placed under the heading "consensual approach", as it reflects the agreement and understanding of the investor and its intermediary.***

B. The compromise reached at the January meeting

As a result of the discussion, the following compromise emerged during the January meeting: the parties to the custody agreement should be able to designate an agreed place as the location of the account, but such an agreed designation would not be conclusive unless it satisfies one of a number of specified tests that indicate that the designated place is where the account is actually maintained. This is in order to prevent third parties being prejudiced by the use of an artificial designation which would conflict with the natural assumptions about the location of the account. Only under those conditions would PRIMA be regarded – and accepted – as a modern reflection of the traditional *lex rei sitae* approach. ***Ignoring the* lex rei sitae *principle for the sake of an unrestricted consensual approach would, however, be seen as having severe implications for long-standing private international law traditions of several countries.***[42]

This compromise, it is submitted, bridges the position initially advocated by those who favoured an unrestricted consensual approach (*i.e.* parties should be allowed to designate *any* location of the account) with the position initially taken by those who argued that no contractual liberty should be left to the parties in relation to the issue of location, with only objective factors used.

This approach was embodied in the draft proposed by the Drafting Group (Work. Doc. No 16). This draft had the following structure. Article 4, paragraph 1, specified that the relevant intermediary was located "where the account is maintained." According to Article 4, paragraph 2, an account was deemed to be maintained at the place agreed between the intermediary and account holder unless that designation was clearly inconsistent with the actual operation of the account in practice, *i.e.* (i) the place must be where the securities intermediary has an "office or branch" and (ii) the securities intermediary must "allocate"[43] the securities account to that office or branch for purposes

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[40] "Party autonomy" in the UCC, for example, refers only to the relation between the investor and the intermediary, not the relation between the investor and the secured party.

[41] Some experts have drawn a parallel with an investor choosing to do business with an intermediary located in State A rather than with an intermediary located in State B, and suggested that although this "choice" would lead to the application of a different law, it would not be accurate to refer to it as an example of "party autonomy".

[42] On this issue, see also *infra*, pp. 20 *et seq*.

[43] On this expression, see *infra*, under C.

of reporting to its account holders, for regulatory or accounting purposes.

If this test did not provide a result, Article 4, paragraph 3 provided that the account was located at the place of office or branch to which the intermediary allocated the account for reporting, regulatory or accounting purposes.

For cases where this second test did not lead to a result, the Drafting Group developed two alternatives for a fallback in Article 4, paragraph 4: (a) the place where the securities intermediary was legally established and (b) the governing law of the custody agreement.

In Article 4, paragraph 5, the draft provided a "black list" with factors that a court should not take into account in applying the tests: the place of the data processing, the place of the certificates, the place of the register, the place of the issuer, the place of any intermediary with which the account holder did not contract to maintain the account and the place of the account holder.

This draft provision was discussed by the plenary session during the final day of the meeting. In order to reflect the results of this discussion, in February 2001 the Permanent Bureau, the Legal Expert to the Permanent Bureau and the Chair of the Drafting Group suggested in February 2001 amended text to the experts for further consideration.

C. Draft of the Permanent Bureau, Legal Expert to the Permanent Bureau and the Chair of the Drafting Group of February 2001

In the February 2001 draft, two changes of substance were made to Article 4, paragraph 2. First, the reference to the account being "deemed" to be maintained at a particular place was placed in brackets in response to concerns of various delegations that it might be viewed as implying an element of artificiality that could eventually threaten the *lex rei sitae* principle. Secondly, the reference to "allocation" of the account was replaced by references to the place where the intermediary "treats" or "records" the account as being maintained. A number of delegations had indeed some difficulty with the term "allocation", particularly in its French translation ("*affectation*"), and it was hoped that the revised text would express more clearly the substance of what is intended.

D. The informal discussions after the January meeting (the March 2001 draft)

As explained above, discussions among the experts continued after the January meeting on an informal basis. In addition, further legal experts, market participants and regulators were involved in these discussions. As a result of these consultations, the Permanent Bureau, together with members of the Drafting Group, proposed an alternative draft of Article 4 in March.

According to the new wording of Article 4, paragraph 2, the party referring to the place agreed between the account holder and the intermediary has to establish that the intermediary actually maintains the account there for regulatory, accounting or internal or external reporting purposes. The new wording of Article 4, paragraph 2, reads as follows:

> "For the purposes of this Convention, the securities account is maintained at the place of the office of the relevant securities intermediary agreed between the account holder and the securities intermediary, provided that the securities

intermediary treats the securities account as being maintained at that office [44] for [a regulatory, accounting or internal or external reporting purpose] [regulatory, accounting or internal or external reporting purposes]."

(a) Ex ante *certainty*

First, Article 4, paragraph 2, appears to address the business need of *ex ante* certainty by looking to the place designated in the custody agreement or other similar agreement (described herein after as the "designated place"). As it is easy to specify such a place, this should provide the clarity and certainty market participants need if they are to perfect in the appropriate jurisdiction. The place designated in the *custody agreement* seems a better solution than the designation in an *account statement*, which may be driven by operational factors. If one were to move directly to the purely balancing test proposed in paragraph 3, the goal of *ex ante* certainty would not be achieved. This being said, the proposed balancing test described below is needed as a fall-back position to be looked at if the place of the account has not been designated in the custody agreement or fails to meet the conditions set out.

(b) Respect of the lex rei sitae *principle*

The second requirement, that the *lex rei sitae* principle must be respected, is also addressed in the March proposal. The goal is to find a test that incorporates factors that would logically indicate that the account is really to be viewed as maintained at the designated place.

(i) Regulatory supervision

The most appropriate factor appears to be whether the account is subject to regulatory supervision in the designated place. This is what is intended by the language in Article 4, paragraph 2, "the intermediary treats the securities account as being maintained at that office for a regulatory purpose." One suggestion made is that the singular rather than the plural be used [at least in the English text] because of the concern that the intermediary may be subject to the regulatory regimes of *two or more jurisdictions* (for example, where a branch is involved) and it needs to be clear that if the account is subject to regulation in the designated place then that should suffice to satisfy Article 4, paragraph 2. Otherwise, *ex ante* certainty will be lost as a judge long after the fact occurred might have to decide which regulatory regime was the appropriate one. Although the general concept seems promising, it will be essential to get input from market participants and lawyers familiar with business practices and the regulatory regimes in different countries in order to devise appropriate final language for a regulatory supervision test.

If all accounts could conveniently be shown to be subject to appropriate regulation at a particular place then one could stop here. However, there may be reasons for considering additional tests. First, some account arrangements are not subject to regulation, for example where the intermediaries are *unregulated entities*. The proposed Convention will only deal with conflict of laws issues and is not designed to impose a substantive regulatory regime on intermediaries – any desire of States to limit a party's use of unregulated entities is a matter for the substantive law in the particular jurisdiction.

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[44] For the sake of simplicity, the term "office" was used throughout, without referring to "office or branch." It was assumed that the term office would be defined to include a branch either in the definition section of the Convention or in an explanatory note.

Hence, the Convention will need to provide a solution for the (exceptional) cases involving unregulated entities. Secondly, given the complexity and variety of regulatory regimes and possibility of multiple or overlapping regulatory jurisdiction, it may be difficult to draft a version of a regulatory supervision test that will work in all cases even for firms that are subject to regulation. This applies in particular to *federal systems* if regulation is done on a national basis. Of course, this may be addressed to some degree by the federal clause in Article 11 of the draft Convention; however, not necessarily in all circumstances for all federal States.

(ii) Accounting regime

In order to address the situation where the "regulatory purposes" test does not provide a result, "accounting purposes" has been added – if the intermediary's holding of accounts flows through to the audited statements (somehow embedded in numbers in line items or in footnotes), that should be sufficient to justify the designated place as well. This may help in some circumstances not covered by the "regulatory purpose" limb but not in all circumstances. Just as the regulatory test may not catch all situations where securities are held in custody, not all situations will be picked up somewhere in accounting statements.

(iii) Internal or external reporting

The recognition that certain situations are not covered by (i) and (ii) above led to the inclusion of the additional element that where the intermediary treats the account as being located at one of its offices for internal or external reporting purposes, that too will suffice. However, during the informal working process undertaken since March, several experts voiced their concern about the lack of precision of these two connecting factors. They questioned whether internal reporting was transparent enough to serve as an appropriate "reality check", adding that the effects of this approach could lead to unpredictable results because of differences in actual practice. As a result, some experts have suggested that these two connecting factors be either described in more detail (*e.g.* by adding an explicit definition in Art. 2) or deleted altogether, leaving situations involving unregulated intermediaries (which are believed to be highly unusual at present) to be dealt with under the fall-back provisions. Obviously more thought is needed to clarify this aspect.

E. The fall-back test in paragraph 3

If Article 4, paragraph 2, is not satisfied, either because there is no designation in the custody or other agreement or because the conditions embodied in the proviso are not fulfilled, then a fall-back test is needed.

(a) Balancing test

The proposed Article 4, paragraph 3, uses an objective balancing of factors test rather than a rule based on a single specified factor or a cascade of single specified factors. The balancing test, although not providing complete *ex ante* certainty, appears acceptable for two reasons. First, the strength of Article 4, paragraph 2, means that commercial parties will be able to determine with certainty the law that will govern perfection in the great majority of cases. Therefore, if Article 4, paragraph 3, applies, this will normally be because the parties did not consider the issue of the location of the account; hence, it appears appropriate that the question of its actual location be decided by considering all the objective evidence. Secondly, the "black list" in Article 4, paragraph 4, makes clear the factors that are *not* to be considered and this will provide far greater certainty than

currently exists. In particular, Article 4, paragraph 4 makes it clear that the so-called "look-through" approach is never to be adopted.

In the March 2001 proposal, paragraph 3 reads as follows:

> "If the place where the securities account is maintained is not determined under paragraph (2), the factors that may be considered in determining the place where the securities account is maintained include the following:
>
> (a) the location of the office where the relevant securities intermediary treats the securities account as being maintained for regulatory, accounting or internal or external reporting purposes;
>
> (b) the location of the office or offices of the relevant securities intermediary with which the account holder deals;
>
> (c) the terms of the custody agreement, account agreement or other agreement relating to the securities account between the relevant securities intermediary and the account holder;
>
> (d) the terms of account statements or other reports prepared by the relevant securities 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."

Sub-paragraph (a) would simply reflect the principles embodied in paragraph 2. Sub-paragraph (a) and its components would certainly seem to be an important factor as part of a balancing test; what is less clear is whether the sub-paragraph's components would make sense as a single fall-back rule. For example, using a test that looks to the place where the account is maintained for regulatory purposes will not provide certainty in cases where there is more than one State that has jurisdiction over it.

Sub-paragraph (b) may be useful in situations where other documentation has not expressly designated the location of the account, but the account holder regularly deals with a certain office or offices with respect to the custodial services provided by the intermediary.

Sub-paragraphs (c) and (d) permit reference to the general terms of account agreements or statements. Both sub-paragraphs can be expected to lead over time to a change in industry practice. As a competitive matter, custodians will ensure that their account agreements and account statements clearly indicate where the account is maintained to provide certainty for their customers. Some experts questioned the inclusion of sub-paragraph (c), as this factor is already contained in Article 4, paragraph 2. There are however two reasons for suggesting that it remains appropriate to refer to the same factors in both places. First, if no place is designated in the custody or other agreement, the terms of the agreement should still be relevant in evaluating the expectations of the parties as to the location of the account. Similarly, if a place has been designated in the custody or other agreement but the proviso in Article 4, paragraph 2 is not satisfied, the terms of the agreement between the parties might still be of relevance in determining the location of the account.

Sub-paragraph (e) has been included in the balancing test as one of the potential fall-backs proposed at the January meeting. This test had the support of some delegations. As one of the factors it would be an additional indication of a connection with a particular place. As a single factor fall-back test, however, it seems unlikely to be acceptable because it leads to an answer that may be divorced from the *lex rei sitae.*

(b) Single factor fall-back tests, in particular the "legally established" test

As mentioned above when considering the balancing test, the factors mentioned in Article 4, paragraph 3, sub-paragraphs (a) and (e) do not seem appropriate as single factor tests.

One suggestion that was discussed at the January meeting was to locate the relevant intermediary at the place where that intermediary signing the custody agreement was *"legally established".* Proponents of this test have suggested that it has the advantage of being clear cut. Others, however, have suggested that it may pose problems due to the varying treatment under different legal systems of the status of branches of multinational organisations, and have questioned whether it will always be feasible to determine whether the contracting party is a branch or the entity as a whole. In such cases, the application of the "legal establishment of the signing party" test could result in the law of the place of incorporation or formation, statutory seat or central administration even though the securities account is not located in that jurisdiction. It has been suggested that this difficulty could be overcome, without abandoning the "legally established" formula, by additional wording making it clear that in cases where the intermediary is dealing through a branch it is to be regarded for this purpose as legally established where the relevant branch is located. This however would lead back to the problem of identifying in each case which branch was the "relevant" branch. Since there may be factors pointing to connections with two or more branches, it does not appear that the use of an expanded "legally established" test of itself provides any greater clarity or certainty.

In a first version of the March 2001 draft, Article 4 provided a test that should make clear that for intermediaries which maintain all accounts within a single State, the Convention will treat the accounts as being maintained in that State. However, there were some concerns that this test might be somewhat circular and redundant. This is because, in order to establish that the intermediary maintains all accounts in a single State, it is necessary to ascertain (presumably applying the factors in paragraph 3) that the particular securities account is maintained in that State. Once this has been done, however, the purpose of Article 4 has been achieved and it becomes irrelevant whether the intermediary maintains other accounts in that State or elsewhere. As a result of these concerns, this test was not retained by the experts.

During the informal process, some experts have made it clear that they would prefer the use of a single fall-back test rather than a balancing test if a suitable single fall-back test can be found. The challenge has been trying to find a test that provides a *single* answer that is linked to the *location where the account is actually maintained*. Experts continue to strive for such a solution and it is expected that new and different suggestions will be considered as the process continues.

F. The "black list" in the March 2001 draft

Article 4, paragraph 4, of the March draft provides the black-listed factors that should not be taken into account in determining the location of the accounts. In comparison with the February draft, the location of the account holder has been removed from the list in order to limit the list to "look-through" factors and make it consistent.

No reference is made to the relevant securities intermediary's place of formation or incorporation, statutory seat or principal place of business. It was thought unlikely, but not inconceivable, that this would have been of any relevance and that accordingly the best course was not to include it in either list.

ARTICLE 5: SCOPE OF THE APPLICABLE LAW

As already mentioned under Article 1,[45] the proposed Convention will only deal with the *proprietary* component of a transaction involving the disposition of indirectly held securities; the *contractual* aspects of an agreement under which such a disposition is made remain covered by separate conflict of laws rules. The purpose of Article 5 is to identify the proprietary aspects which will actually be governed by the substantive law of the PRIMA jurisdiction. In doing so, Article 5 determines the *scope of the applicable law*. Pursuant to the substantive scope of application of the Convention itself, the scope of the applicable law determined in Article 5 applies to the proprietary aspects of dispositions of all kinds.

The proprietary aspects governed by the substantive law of the PRIMA jurisdiction include first the *"legal nature"* of the rights constituting an account right. As already explained under Article 1,[46] the legal nature of an investor's interest in securities held through indirect holding systems varies among different legal systems and jurisdictions (basically, these interests can be *proprietary* or *contractual*, the result of a *new legal structure not involving co-ownership,* or *trust* interests). In Article 5(a), the suggested preliminary draft clearly indicates that this question remains left to the substantive law of the PRIMA jurisdiction. In other words, the proposed Convention itself will *not* interfere with the legal nature of an investor's interest in the indirectly held securities and will not impose any change on a State's substantive law in this regard. As a result, 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 reference to the "legal nature" presumably also includes the validity of a provision under which the collateral taker is given the right to use the pledged securities for its own purposes, including the right to transfer them to a third party. Such a right is sometimes referred to as a right of "rehypothecation", though it generally extends to all kinds of onward dispositions and not merely to onward dispositions by way of pledge. Whether such a right may validly be created will be a matter both of the law governing the relevant contract and of the law governing proprietary aspects of the transaction. This is, therefore, one of the matters falling within the scope of the applicable law designated by the proposed Convention.[47] On the other hand, it has to be stressed that the proposed Convention does *not* address the substantive law issue of so-called "upper-tier attachment" – that is, the problem that arises where a person with an interest at a lower level in the chain of holdings (for example, a person claiming to have acquired rights from an investor) seeks to attach or otherwise claim an interest in securities or an interest in securities held at a higher level where there is no record of that person's entitlement.[48]

As regards Article 5(b), two changes have been made in the February draft. First, the words "the proprietary aspects of" have been added and the word "acquisition" placed in square brackets. This is in response to concerns raised by one delegation that the word "acquisition" could be interpreted as extending the Convention to *non*-proprietary questions, which is by no means the intention. The second change is that references to "variation" and "extinction" of an account right have been added in response to the suggestion made by one delegation, which seemed to be generally supported at the Plenary Session.

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45 See *supra*, p. 5.

46 See *supra*, p. 6.

47 One may note that Art. 6 of the proposed EU Collateral Directive requires Member States to ensure that such a right is recognised as valid under their substantive law.

48 See Prel. Doc. No 1, p. 5 and footnote 113 with accompanying text.

Furthermore, it is important to stress that the Convention does *not interfere with the question as to how contractual transfers of property operate in the various legal systems* (*i.e.* principle of consent[49] or principle of delivery ("*traditio*")). The basic issue addressed in Article 5(b) is to know whether the property right has been "created" or not and whether it can be validly disposed of.

Regarding Article 5(c), it has already been mentioned in relation to Article 2 that the February draft has included the definition of the term "perfection" in Article 2. No other change of substance has been made to this provision.

Article 5(d) states that the question of priority among competing claims will be governed by the substantive law of the PRIMA jurisdiction. This could also cover issues commonly described in some legal systems as whether a person who acquires an interest takes that interest free from adverse claims. In addition, this law will also determine the possible duties of a securities intermediary to a person who asserts an adverse claim to the account holder's interest.

Finally, Article 5(e) covers proprietary aspects of realisation -- questions as to *whether* and *in what manner* a collateral taker may sell or realise the collateral once there has been a default by the collateral provider.

ARTICLE 6: INSOLVENCY

INTRODUCTION

This important provision addresses the delicate question of the effects of a bankruptcy procedure on a transaction (in particular a *collateral* transaction) whose proprietary aspects are governed by the substantive law of the PRIMA jurisdiction.[50] At the outset, it should be noted that insolvency laws might have an impact in two ways on the law applicable to the taking of securities as collateral. First, insolvency laws might impact *whether a proprietary interest has been properly created and perfected*. Secondly, insolvency laws might jeopardise the *effects* of such interest within a bankruptcy procedure. The proposed Convention addresses both these issues in Article 6. It aims at finding the delicate balance between preserving the effectiveness of an interest perfected under PRIMA, while not vitiating rules in bankruptcy that affect secured parties.[51]

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[49] One may add, however, that in the context of indirectly held securities, the principle of consent may not be effective in its traditional form. In English and Italian law, for example, the appropriate provisions clearly state that the general principle applies only to the transfer of property in *specific* goods, while in France the principle only applies in relation to "immediately identifiable" goods. In an indirect holding structure based on fungible accounts, however, the securities are neither "specific" nor "immediately identifiable". Hence, in legal systems based on the principle of consent, subsidiary rules are needed to apply the principle to transfer of generic goods.

[50] As a matter of fact, the crucial question with respect to a pledge is its efficacy in the event of the debtor's insolvency. This being said, States have always been very sensitive to any possible intrusion into their domestic insolvency law regime. It is against this background that Prel. Doc. No 1, p. 5, suggested that the proposed Convention should not interfere with national insolvency rules. This issue had not been discussed in full detail during the informal discussions prior to the January meeting; the matter was in fact deliberately left for discussion at the January experts meeting.

[51] The provision is drafted without specifying against whom the insolvency proceedings are brought. This way, it covers any relevant insolvent debtor, including the intermediary.

A. Respect of validly perfected interests (paragraph 1)

A large number of experts endorsed the principle that an interest validly perfected under PRIMA should be respected under the provisions of specific insolvency laws. This is stated as a general principle in Article 6, paragraph 1. The general principle is subject to exceptions, the scope of which raises important policy issues which are discussed further below. It was, however, generally agreed that the exceptions should not be phrased so as to permit the insolvency court to apply a conflicts rule different from PRIMA in identifying the law to govern proprietary issues such as creation and perfection. The approach taken in paragraph 1 is based on both the *Council Regulation (EC) No 1346/2000 on Insolvency Proceedings* (Art. 5, para. 1),[52] and on the *Draft UNIDROIT Convention on International Interests in Mobile Equipment* (Art. 29, paras. 1 and 2).[53]

The creation, validity and scope of *in rem* rights are governed by their own applicable law (in general, the *lex rei sitae*, or, in the specific context of indirectly held securities, PRIMA). The fundamental policy pursued in paragraph 1 is to give effect to a right created under the law of the State where the assets are "situated" and hence can

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[52] This Regulation, which entered into force on 31 May 2001, has been adopted with a view to developing more uniform procedures that will avoid incentives for the parties to transfer assets or judicial proceedings from one Member State to another in order to obtain a more favourable legal position. The proposed solutions rely on the principle of proceedings with universal scope, while retaining the possibility of opening secondary proceedings within the territory of the Member State concerned. The Regulation applies "to collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator" (Art. 1, para. 1). It applies equally to all proceedings, whether the debtor is a natural person or a legal person, a trader or an individual. However, it does not apply to insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings which provide services involving the holding of funds or securities for third parties, and collective investment undertakings (Art. 1, para. 2). The courts with jurisdiction to open insolvency proceedings are those of the Member State where the debtor has his centre of "main interests" (Art. 3, para. 1; in the case of a company or legal person, this is the place of the registered office, in the absence of proof to the contrary). Secondary proceedings may be opened subsequently to liquidate assets located in another Member State (Art. 3, para. 2; these secondary proceedings are restricted to the assets of the debtor located in the other Member State). The law of the Member State in which proceedings are opened determines all the effects of those proceedings (Art. 4; conditions for the opening of the proceedings, their conduct and closure, questions of substance such as the definition of debtors and assets, effects of proceedings on contracts, individual creditors, claims, etc.). However, the *in rem* rights of third parties in respect of the debtor's assets located in another Member State are not affected by the opening of an insolvency proceeding in another Member State (see further comments on this issue in the text). Art. 5, para. 1 reads as follows: "The opening of insolvency proceedings shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible, moveable or immoveable assets – both specific assets and collections of indefinite assets as a whole which change from time to time – belonging to the debtor which are situated within the territory of another Member State at the time of the opening proceedings." One may add, however, that this immunisation is only *partial*, as the liquidator may request secondary proceedings to be opened in the State where the assets are located if the debtor has an establishment there. Finally, decisions by the court with jurisdiction for the main proceedings are, in principle, recognised immediately in the other Member States without further scrutiny (Art. 16).

[53] Article 29 of this Draft Convention (as approved by the UNIDROIT Governing Council at its 79th session, held in Lisbon from 10 to 13 April 2000) reads as follows:

"1. In insolvency proceedings against the debtor an international interest is effective if prior to the commencement of the insolvency proceedings that interest was registered in conformity with this Convention.

2. Nothing in this Article impairs the effectiveness of an international interest in the insolvency proceedings where that interest is effective under the applicable law.

3. Nothing in this Article affects any rules of insolvency law relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors or any rules of insolvency procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator."

eventually be enforced. In other words, the system preserves legal certainty of the rights over these assets. Rights *in rem* can only properly fulfil their function if they are not more affected by the opening of insolvency proceedings in other States than they would be by the opening of national insolvency proceedings.

B. The qualifications (paragraph 2)

In the February 2001 draft of Article 6, the principle stated in paragraph 1 is subject to two important qualifications embodied in paragraph 2. These qualifications are based on the *Draft UNIDROIT Convention on International Interests in Mobile Equipment.*

(a) Draft UNIDROIT Convention on International Interests in Mobile Equipment

Like Article 29, paragraph 3, of the *Draft UNIDROIT Convention on International Interests in Mobile Equipment*, the February 2001 draft of Article 6, paragraph 2, aims at:

(a) preserving certain rules relating to insolvency proceedings such as the *ranking* of categories of claims and *avoidance rules*; and

(b) avoiding interfering with rules about the enforcement of real rights or security interests pending *reorganisation*.

The basic reasoning underlying sub-paragraph (a) is to preserve insolvency rules which may declare that certain types of claims (*e.g.* wages and taxes) should have priority over any other interest. Several experts stated that in their respective jurisdictions such insolvency rules would have public policy character and hence would have to prevail over any other interest.[54] Furthermore, to ensure that reorganisation proceedings do not collapse (because, for example, a secured party seizes crucial assets), sub-paragraph (b) is designed to subject the security interest to such procedures (*e.g.* a stay).

A first group of experts agreed with the principles underlying Article 6. Another group, however, questioned the qualifications in paragraph 2 and its effect to of submitting the interests in the pledge to the *lex concursus*. In their opinion, the effects of paragraph 2 would be too far-reaching. Instead, these experts suggested that the proprietary rights of the beneficiary in cases of insolvency should be determined *exclusively* in accordance with PRIMA. This approach, which expands the effects of PRIMA to the detriment of the *lex concursus*, is inspired by the *European Insolvency Regulation*. During the January meeting and in subsequent informal discussions, a number of experts have stressed that it was important to ensure compatibility between the proposed Hague Convention and the European Legislation. The general focus of the proposed Convention, however, should remain on PRIMA and it may be worthwhile not to bee too ambitious on insolvency issues so as not to lose sight of the principal aim of the project.

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[54] Another group of experts expressly questioned this conclusion. During the meeting, one expert suggested that all delegations should enquire in their own jurisdictions whether the cases listed in paragraph 2 would in fact be regarded as falling under the public policy exception.

(b) The European Insolvency Regulation

As already mentioned, Article 5, paragraph 1 of the European Insolvency Regulation (EIR) excludes from the effects of the proceedings rights *in rem* of third parties and creditors in respect of assets belonging to the debtor, which, at the time of the opening of proceedings, are situated within the territory of another Contracting State.[55] Similar to the *Draft UNIDROIT Convention*, the EIR does not "immunise" rights *in rem* against the debtor's insolvency altogether.[56] According to Article 5, paragraph 4, the principle of protection embodied in paragraph 1 "shall not preclude actions for voidness, voidability or unenforceability as referred to in Article 4(2)(m)."[57] Pursuant to the latter provision, these actions are governed by the *lex concursus*. So far, the system is comparable to the one embodied in the *Draft UNIDROIT Convention*. Article 5, paragraph 4, however, has to be read in conjunction with Article 13 of the EIR. Article 13 is indeed crucial, as it states that the possibility of an action for voidness, voidability or unenforceability under the *lex concursus* "shall not apply where the person who benefited from an act detrimental to all creditors provides proof that:

- the said act is subject to the law of a Member State other than that of the State of the opening of proceedings, and
- that law does not allow any means of challenging that act in the relevant case."

Hence, if prior to the opening of the debtor's insolvency proceedings, a collateral taker has fulfilled all the perfection requirements under PRIMA, and the collateral taker's interest is not subject to further challenge under the PRIMA jurisdiction's law, the collateral taker's interest should be given full effect and not be affected by the *lex concursus*. Accordingly, if the conditions for an *actio pauliana* would be fulfilled under the *lex concursus*, but not under the PRIMA jurisdiction (because, for example, the suspect period is shorter in the latter than in the former), the collateral taker's interest would remain protected. If, on the other hand, the PRIMA jurisdiction's law *does* allow for the act to be challenged, the appropriate steps may be taken to set aside the acquisition or disposition of the account right concerned.

Article 13 represents a defence against the overriding application of any provision of the *lex concursus* invalidating the collateral taker's interest in circumstances where it is not possible to invoke a corresponding invalidating provision under the law of the PRIMA jurisdiction. This mechanism is said to be "easier to apply than other possible solutions based on the cumulative application of the two laws" and to "uphold legitimate expectations of creditors or third parties of the validity of the act in accordance to the normally applicable national law, against interference from a different 'lex concursus' ".[58]

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[55] See *supra*, footnote 52 and accompanying text. If the assets are situated in a non-Contracting State, Art. 5 is not applicable.

[56] It has to be noted that the EIR does not define what "rights *in rem*" are. If it were to impose such a definition, it would indeed run the risk of describing as rights *in rem* legal positions which the law of the State where the assets are located does not consider to be rights *in rem*, or of not encompassing rights *in rem* which do not fulfil the conditions of that definition. Hence, the classification of a right as a right *in rem* must be sought in the national law which, according to the general conflict of laws principles, governs rights *in rem* (*i.e.* in general, the *lex rei sitae*, or in the context of indirectly held securities, the PRIMA jurisdiction).

[57] Furthermore, if the law of the State where the assets are located allows these rights *in rem* to be affected in some way, the liquidator (or indeed any other person thus empowered) may request secondary proceedings to be opened in that State if the debtor has an establishment there. The secondary proceedings are conducted according to national law and allow the liquidator to affect these rights under the same conditions as in purely domestic proceedings.

[58] These quotations are from the *Explanatory Report on the European Convention on Insolvency Proceedings* prepared by Prof. Virgós (Spain) and Mr Schmit (Luxembourg). In essence, the Regulation is a mere transcript of the Convention and hence the Explanatory Report may still be consulted with benefit.

For the collateral taker, this system enhances certainty and thus represents an advantage: he only has to look at one single law for both the perfection requirements and the extent of protection offered in case of the debtor's insolvency and his expectations would be respected.[59]

CONCLUSIONS

This brief analysis indicates that there seems to be agreement on the principle that local insolvency rules should not be permitted to apply a principle different from PRIMA to identify the law applicable to proprietary issues such as whether an interest has been validly created and perfected. There is, however, no consensus as yet as to the extent of any further protection which should be given to any rules of the PRIMA jurisdiction against the application of differing rules of the insolvency, for example, in relation to matters such as the invalidation of transactions on the grounds of preference or fraud on creditors. Two concepts are proposed: one that is guided by the aim of preserving the effects of the local insolvency law,[60] and another that aims at preserving the collateral taker's interest by giving PRIMA the greatest possible effect in the debtor's insolvency procedure. No consensus has yet been reached on this crucial question and further discussions are needed.

ARTICLE 7: GENERAL APPLICABILITY

A conflict of laws rule embodied in a convention is said to be generally applicable if the law designated by the rule applies irrespective of whether or not the State whose legal order has been designated is a Party to the convention (in French, this is often referred to as a convention *portant loi uniforme*; another expression is to say that the convention is applicable *erga omnes*).

During informal discussions prior to the January meeting, as well as during the meeting itself, there was consensus among the experts that the Convention should be generally applicable. Thus, the provisions of the proposed Convention should apply even if the law designated by the proposed Convention is the law of a non-Contracting State. Both the principle embodied in Article 7 and the actual language are in line with modern Hague Conventions on conflicts of laws. This approach has the considerable advantage that States which decide to become a party to the proposed Convention would obtain the desired certainty and predictability, without having to wait for others to join.

ARTICLE 8: EXCLUSION OF *RENVOI*

During informal discussions prior to the January meeting, as well as during the meeting itself, there was consensus among the participants that the Convention should leave no room for *renvoi*. This is in line with the tradition of the modern Hague Conventions on the

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[59] A similar solution is proposed in the *Draft UNCITRAL Convention on Assignment of Receivables in International Trade.* In the case of investment securities held through a securities intermediary, the characteristics and priority of the assignee in proceeds are governed by PRIMA (Art. 24, para. 1, sub-para. b; Art. 31), except in two situations: first, where the substantive provision of the PRIMA jurisdiction would be manifestly contrary to the public policy of the forum State, and secondly, where non-consensual preferential rights (such as wages and tax) are given priority in the forum State (Art. 25 and 31).

[60] During informal discussions subsequent to the January meeting, a group of experts stressed that the proposed Hague Convention should refrain from interfering with local insolvency laws. As a result, they suggested that para. 2 should be deleted altogether and that Art. 6 should be limited in stating the principle embodied in para. 1 only.

conflict of laws which, in general, exclude any form of *renvoi*. If the designation of the applicable law were to include the PRIMA jurisdiction's private international law rules, one would reintroduce an element of uncertainty and thereby frustrate the purpose of the proposed Convention: if, within a *renvoi* concept, the PRIMA jurisdiction's private international law rules point to the law of a State which is not a Party to the proposed Convention and which in fact has adopted a different approach to the question at stake, for example the "look-through approach", the parties to a transaction would lose all the benefits of certainty and predictability that the proposed Convention is designed to provide.[61]

ARTICLE 9: INTERNATIONAL MANDATORY RULES

A. Mandatory rules of the *forum*

At the outset, it is important to note that in the present context the term "mandatory rules" is used in an "international sense", that is, it refers to rules which *must* be applied to the issue before the court *regardless of any choice of law by the parties or any rule of the local private international law under which the issues would otherwise be referred to another legal system*. This idea of "directly" applicable rules (in the sense that they short-cut traditional private international law mechanisms) is quite appropriately reflected in the French expression *lois d'application immédiate;* the German expression *Eingriffsnormen* is equally pertinent.

During the informal discussions prior to the January meeting, the experts seemed to agree that the mandatory rules of the forum *should* remain applicable in addition to the provisions designated under PRIMA. It was mainly argued that it was unlikely that a judge would disregard the mandatory rules of the forum: these rules are to be regarded as an expression of fundamental values which are so important that, as a matter of policy, the rules must apply in any action before a court of the forum, even where the issues are in principle governed by a foreign law.

During the January meeting, however, the principle mentioned above was severely confined. The experts unanimously stressed that if perfection or priorities rules of the forum were to be applied, the PRIMA principle would be seriously undermined and an element of uncertainty reintroduced. As a result, it was agreed that only those mandatory rules of the forum would have to be applied which *do not impose requirements with respect to perfection and do not relate to priorities*. In other words, any rule of the *forum* that requires a different mechanism of perfection than the mechanism applicable under PRIMA is not a mandatory rule in the sense of Article 9. As a result, an interest perfected

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[61] It is worth noting that the proposed *EU Collateral Directive* (as released by the Commission on 27 March 2001) also excludes *renvoi* (Art. 10, para. 1); similarly, the reference to "local law" in Art. 8-110 UCC refers to the law of a jurisdiction other than its conflict of laws rules (see Official Comment, UCC, 2000 Edition, p. 712).

under PRIMA may not be invalidated merely because it does not comply with a perfection requirement of the *forum*.[62]

The issue then arises of situations where the *forum* (*e.g.* the investor's jurisdiction) imposes a perfection requirement that has to be *fulfilled in another jurisdiction* (*e.g.* registration in a public register of the issuer's jurisdiction). This question was briefly discussed during the January meeting. The experts unanimously agreed that such a perfection requirement could *not* be regarded as an international mandatory rule, because it imposes an act to be taken in a different jurisdiction. Mandatory rules, however, are self-confined to the territory of the relevant jurisdiction.

B. Mandatory rules of third States

The experts also discussed the question of whether mandatory rules of third States should be taken into consideration.

The concept of mandatory rules of third States may be illustrated by way of an example in which it is assumed that the securities held by an investor through an intermediary located in State Y are securities issued by a corporation formed under the laws of State X, and the investor provides its interests in these securities as collateral under a pledge mechanism. Let us further assume that the law of State X requires that all pledges over securities issued by corporations incorporated in State X be filed in a public register in State X. Under this fact pattern, the question could arise as to whether the law of State X has to be taken into consideration in addition to the law of State Y which, as a result of PRIMA, governs the proprietary aspects of the collateral transaction.

There was clear and swift consensus among the experts that mandatory rules of third States should *not* be taken into consideration. In fact, not one expert was in favour of retaining the concept of mandatory rules of third States in the proposed Convention. Any requirement to take into consideration the mandatory rules of a third State would indeed potentially reintroduce an element of uncertainty and thus frustrate the purpose of the proposed Convention. During informal discussions prior to the meeting, it had already been stressed that although admitted in some countries in a contractual context in particular, the concept of mandatory rules of third States is not appropriate in the context of proprietary rights. If mandatory rules of a third State were to be considered, at least two subsequent issues would arise: (i) would the law of any third country be relevant or only that of a country with a close and substantial connection? (ii) should the application of the mandatory law of the third country be mandatory itself or be at the discretion of

[62] The mechanism proposed in Art. 9 is similar to the one suggested in Art. 25 of the draft UNCITRAL Convention on Assignment of Receivables. According to the latter, mandatory rules of the *forum* apply except for the issues of perfection or priority. Non-consensual preferential rights, however, are *not* excluded (in other words, they are an exception to the exception; for more details, see also *infra*, footnote 63). The experts may wish to clarify this point, but it is suggested here that the same exception with regard to non-consensual preferential rights would probably apply under the proposed Hague Convention. The scope of the latter is indeed limited to *consensual* transactions as opposed to rights arising by *operation of law* (see comments under Article 1). As a result, the exclusion in Art. 9 can also only apply to consensual transactions, leaving non-consensual preferential rights intact. If the experts aim at a different outcome, there should be a explicit reference in the text of the proposed Convention.

the forum? Given the potential uncertainty that the concept might introduce, it seemed preferable to the experts to abandon this concept in the proposed Convention.[63]

Obviously, the exclusion of mandatory rules of third States does not cover bankruptcy rules of a foreign country which fall under Article 6. The latter may be regarded as a *lex specialis* to Article 9.

ARTICLE 10: PUBLIC POLICY

Article 10 contains the traditional public policy *(ordre public)* exception that can be found in most private international law treaties dealing with conflict of laws issues. As is the case for all modern Hague Conventions, the exception states that a provision may only be refused if its application is *manifestly* incompatible with the public policy of the *forum*.

Article 10 can be regarded as the "negative" facet of public policy, *i.e.* a technique which leads to the *refusal* or *rejection* of applying a specific norm. By contrast, Article 9, which deals with the concept of mandatory rules, can be regarded as the "positive" facet of public policy, *i.e.* a technique which *imposes* or *requires* that a specific norm be applied. Although these facets use different techniques, they have the same purpose: to make sure that the public policy of the forum is respected. Against this background, one may ask whether Articles 9 and 10 should not be merged into one single provision. The heading of the provision could be: "positive and negative public policy". This might be more easily understood by non PIL-experts than a reference to the concept of "mandatory rules". If so, paragraph 1 of the new provision could reproduce the current Article 9 (which short-cuts the traditional conflict of laws approach), and paragraph 2 the idea contained in Article 10 (which may only come up at the end of a traditional conflict of laws analysis).

As regards Article 10, however, one may wonder if its actual wording should not be amended so as to bring it into line with Article 9, which expressly excludes from its scope all provisions of the *forum* imposing perfection requirements or relating to priorities. In its present form, Article 10 does *not* contain a similar exclusion. This, however, should not be interpreted as allowing the perfection requirements or priority rules of the forum to be "excluded through the door of international mandatory rules, and reintroduced through the window of the public policy"! In other words, under Article 10, one may not argue, as a first step, that foreign perfection requirements or priority rules violate the public policy of the forum simply because they are different from the rules of the forum and then, as a second step, apply the perfection requirements or priority rules of the forum. Arguably, this is clear under the existing wording when one takes into account the fact that the violation of public policy has to be manifest – a mere difference in content does not suffice – and the need to construe Articles 9 and 10 together as closely linked provisions. However, this could perhaps be made clearer by a single provision with appropriate comments in the Explanatory Report.

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[63] According to Article 31 of the *Draft UNCITRAL Convention on Assignment of receivables in international trade,* the forum may set aside rules of the applicable law and instead apply not only its own mandatory rules but also the rules *of another State*. At first sight, therefore, the draft UNCITRAL Convention seems to take a different path than the proposed Hague Convention. It should be added, however, that in the context of the draft UNCITRAL Convention the setting aside of the priority or perfection provisions of the applicable law is not allowed on the basis that those provisions are of mandatory nature themselves and that setting them aside could result in uncertainty that would have a negative impact on the cost or the availability of credit (see *supra*, footnote 62, and the Report of the Working Group on International Contract Practices on the work of its twenty-third session (Vienna, 11-22 December 2000), Doc. Number A/CN.9/486, 9 January 2001, para. 88).

ARTICLE 11: STATES WITH MORE THAN ONE LEGAL SYSTEM

This provision embraces two standard principles relating to States with more than one legal system. Paragraph 1 determines that States with different territorial units having their own rules of law in respect of any matter dealt with in the Convention shall not be bound to apply this Convention to conflicts solely between the laws of such units. Furthermore, according to paragraph 2, any reference to the place of the relevant securities intermediary within such a State shall be construed as referring to the territorial unit of the relevant securities intermediary.

The provision, however, does not address another proposal submitted for discussion during the January meeting and which related to *developing countries* in particular. Several Member States and observers indeed sponsored a Working Document designed to ensure that the proposed Convention does not impede developing countries which, pending modernisation of their own laws, wish to make it easier for parties to agree that the laws of a more developed system will apply to proprietary issues which would otherwise have been governed by their own local law. The following example may explain the purpose of the proposal: Imagine the State of Ruritania (R), a fictional country whose legal system is not well developed. The government of R plans to set up an intermediary, with R (and possibly foreign) investors holding through the R intermediary and making transfers and pledges to R (and possibly foreign) banks. As the law of Ruritania is not developed yet, officials wish the transactions to be governed by the law of X, a State with a modern legal system, including rules fully adapted to indirectly held securities. The sponsors of the Working Document wished to include in the Convention a provision allowing the government of Ruritania to make a *declaration* that an agreement between an investor and an intermediary designating a jurisdiction other than Ruritania as the place of the account would be regarded as effective even if it would not satisfy Article 4, paragraph 2, in a situation where otherwise under the Convention the law of Ruritania would be the law applicable to proprietary issues.

The Working Group seemed willing to work toward a possible solution on this issue, without having expressly accepted or rejected the model suggested. A more detailed discussion, however, had to be deferred to a later stage. The issue was not addressed during the informal working process subsequent to the January meeting and further analysis is therefore needed. After the January meeting, the delegation of one federal system has suggested that the language of Article 11 may need to be adjusted to accomplish several objectives, including more clear coverage of systems having central as well as territorial units, enhancing transparency by providing that States which have multiple systems of law make declarations to that effect, and clarifying that in relation to the choice between the laws of two territorial units of a federal system, the internal choice of law rules of the federal system must also be followed if the forum is another State.

CONCLUSIONS

In June 2001, the Hague Conference will hold Part One of its Nineteenth Diplomatic Session. As a part of this meeting, a Commission on General Affairs and Policy will decide how to proceed with the project of a Convention on the law applicable to proprietary aspects of dispositions of indirectly held securities.

While the results of the January 2001 Working Group are extremely positive, there is still a substantial amount of work that remains to be done. Against this background, the Permanent Bureau suggests that the recommendation made by the *Special Commission of May 2000 on general affairs and policy of the Conference* to prepare a Convention on this issue be:

(i) *confirmed by the Diplomatic Session and put on the agenda of the Hague Conference, and*

(ii) given *priority* with a view to adopting the final text of the Convention in 2002.

ANNEXE / APPENDIX A

LISTE DES PARTICIPANTS À LA RÉUNION DU GROUPE DE TRAVAIL D'EXPERTS
(15 AU 19 JANVIER 2001)

LIST OF PARTICIPANTS OF THE WORKING GROUP OF EXPERTS
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APPENDIX B

TENTATIVE TEXT OF THE KEY PROVISIONS FOR A FUTURE DRAFT CONVENTION (WORKING DOCUMENT NO 16 OF THE JANUARY MEETING, SUBMITTED BY THE DRAFTING GROUP; "JANUARY 2001 DRAFT")

Article 1 Scope of the Convention

(1) This Convention determines the law governing the proprietary aspects of dealings in securities credited to a securities account with a securities intermediary.

(2) *Variation A:*

[This Convention shall not apply where all the relevant factual elements of the situation are located in one State.]

Variation B:

[more detailed rule, *e.g.* parties, account and issuer of securities located in same State]

Article 2 Interpretation

In this Convention:

(1) "securities" means any stock, share, bond, or other financial asset or instrument, or any interest therein, that may be credited to a securities account with a securities intermediary;

"securities intermediary" means a person that maintains for others accounts to which securities are credited and is acting in that capacity or for its own account;

"securities account" means an account with a securities intermediary to which securities are credited;

"account right" means the aggregate of the rights of an account holder derived from a credit of securities to a securities account;

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

"disposition" means pledge or transfer of title, whether outright or by way of security;

"pledge" means a mortgage or a charge or any other form of security interest which is not a transfer of title;

"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.

["Statutory lien" to be raised before Plenary Session]

(2) references to a disposition of an account right include a disposition to or in favour of the account holder's securities intermediary.

Article 3 Determination of the applicable law

Dealings in securities credited to a securities account are governed by the law of the place of the relevant securities intermediary.

Article 4 Determination of place of relevant securities intermediary

(1) In this Convention, the place of the relevant securities intermediary means the place where the securities account is maintained.

(2) The securities account is deemed to be maintained at the place agreed between the account holder and its securities intermediary, provided that such place is a place where the securities intermediary has an office or branch and the securities intermediary allocates the securities account to that office or branch for purposes of reporting to its account holders or for regulatory, tax or accounting purposes.

(3) In the event that the place where the securities account is deemed to be maintained is not determined pursuant to paragraph 2, the place where the securities account is maintained is:

(a) the place of the office or branch to which the relevant securities intermediary allocates the securities account for:

(i) purposes of reporting to its account holders; or

(ii) if not allocated for such purposes, regulatory or accounting purposes; or

(b) *Variant 1:*

if (a) does not apply, the place where the securities intermediary that has contracted to maintain the securities account is legally established.

Variant 2:

if (a) does not apply, the State whose law governs the agreement establishing the account.

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

(a) the place where the technology supporting the bookkeeping or data processing is located;

(b) the place where certificates representing or evidencing securities are located;

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

(d) the place where the issuer of the securities is organised or incorporated or has its statutory seat or registered office;

(e) the place where any intermediary other than the securities intermediary that has contracted to maintain the securities account is located;

(f) the place where the account holder is located;

Article 5 Scope of the applicable law

The applicable law shall determine:

(a) the legal nature of the rights constituting an account right;

(b) any acquisition or disposition of an account right;

(c) any steps necessary to render a disposition of an account right effective against persons who are not parties to that disposition (perfection);

(d) the priority of any person's title to or interest in the account right as against any competing title or interest and the duties, if any, of a securities intermediary to a person who asserts an adverse claim to the account holder's interest; and

(e) any steps required for the realisation of an account right subject to a pledge.

Article 6 Insolvency

(1) The opening of an insolvency proceeding shall not affect the effectiveness of an acquisition or disposition of an account right, constituted and perfected in accordance with the law of the place of the relevant securities 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.

Article 7 General applicability

This Convention applies even if the applicable law is that of a non-Contracting State.

Article 8 Exclusion of *renvoi*

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

Article 9 International mandatory rules

The 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.

Article 10 Public policy

The provisions of any law determined by this Convention may be disregarded when their application would be manifestly incompatible with public policy.

Article 11 Federal clause

(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 securities intermediary shall be construed as referring to the territorial unit of the relevant securities intermediary.

APPENDIX B

APPENDIX C

SUGGESTION FOR AMENDMENT OF THE TEXT OF WORKING DOCUMENT NO 16 SUBMITTED BY THE PERMANENT BUREAU, THE LEGAL EXPERT TO THE PERMANENT BUREAU AND THE CHAIR OF THE DRAFTING GROUP ("FEBRUARY 2001 DRAFT")

Article 1 Scope of the Convention

(1) This Convention determines the law governing proprietary aspects of dealings in securities held indirectly through a securities account.

(2) This Convention applies in all cases involving a choice between the laws of different States.

Article 2 Interpretation

(1) In this Convention:

"securities" means any stocks, shares, bonds or other financial assets or instruments, or any interest therein, that may be credited to a securities account;

"securities intermediary" means a person that maintains for others accounts to which securities are credited and is acting in that capacity or for its own account;

"securities account" means an account with a securities intermediary to which securities are credited;

"account right" means the aggregate of the rights of an account holder derived from a credit of securities to a securities account;

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

"disposition" means a pledge or outright transfer of title;

"pledge" includes mortgage, charge and any other form of security interest which is not an outright transfer of title;

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

"insolvency administrator" means a person or body, including one appointed on an interim basis, authorised in an insolvency proceeding to administer the reorganisation 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.

(2) References in this Convention to an account right include any interest in an account right.

(3) References in this Convention to a disposition of an account right include a disposition to or in favour of the account holder's securities intermediary.

Article 3 Determination of the applicable law

Proprietary aspects of dealings in securities credited to a securities account are governed by the law of the place of the relevant securities intermediary.

Article 4 Determination of the place of the relevant securities intermediary

(1) In this Convention, the place of the relevant securities intermediary means the place where the securities account is maintained.

(2) For the purposes of this Convention, the securities account is [deemed to be] maintained at the place agreed between the account holder and its securities intermediary, provided that such place is a place where the securities intermediary has an office or branch and the securities intermediary [treats][records] the securities account as being maintained at that office or branch for purposes of reporting to its account holders or for regulatory or accounting purposes.

(3) If the place where the securities account is [deemed to be] maintained is not determined under paragraph (2), the place where the securities account is maintained is:

(a) the place of the office or branch at which the relevant securities intermediary [treats][records] the securities account as being maintained for purposes of reporting to its account holders;

(b) if the place where the securities account is maintained cannot be determined under sub-paragraph (a), the place of the office or branch at which the relevant securities intermediary [treats][records] the securities account as being maintained for regulatory purposes;

(c) if the place where the securities account is maintained cannot be determined under sub-paragraphs (a) or (b), the place of the office or branch at which the relevant securities intermediary [treats][records] the securities account as being maintained for accounting purposes;

(d) *Variant 1:*

if the place where the securities account is maintained cannot be determined under any of sub-paragraphs (a) to (c), the place where the securities intermediary which has contracted with the account holder to maintain the securities account is legally established;

Variant 2:

if the place where the securities account is maintained cannot be determined under any of sub-paragraphs (a) to (c), the State whose law governs the agreement establishing the securities account.

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

(a) the place where the technology supporting the bookkeeping or data processing is located;
(b) the place where certificates representing or evidencing securities are located;
(c) the place where any register of holders of securities maintained by or on behalf of the issuer of the securities is located;
(d) the place where the issuer of the securities is organised or incorporated or has its statutory seat or registered office;
(e) the place where any intermediary other than the securities intermediary that has contracted with the account holder to maintain the securities account is located; or
(f) the place where the account holder is located.

Article 5 Scope of the applicable law

The applicable law determines:

(a) the legal nature of the rights constituting an account right;

(b) the proprietary aspects of any [acquisition,] variation, disposition or extinction of an account right;

(c) any requirements for perfection of a disposition of an account right;

(d) the priority of any person's title to or interest in the account right as against any competing title or interest and the duties, if any, of a securities intermediary to a person who asserts an adverse claim to the account holder's interest; and

(e) any steps required for the realisation of an account right subject to a pledge.

Article 6 Insolvency

(1) The opening of an insolvency proceeding shall not affect the effectiveness of an acquisition or disposition of an account right, constituted and perfected in accordance with the law of the place of the relevant securities 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.

Article 7 General applicability

This Convention applies even if the applicable law is that of a non-Contracting State.

Article 8 Exclusion of renvoi

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

Article 9 International mandatory rules

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.

Article 10 Public policy

The provisions of any law determined by this Convention may be disregarded when their application would be manifestly incompatible with public policy.

Article 11 States with more than one legal system

(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 securities intermediary shall be construed as referring to the territorial unit of the relevant securities intermediary.

APPENDIX D

FURTHER SUGGESTION FOR ARTICLE 4 SUBMITTED BY THE PERMANENT BUREAU, THE LEGAL EXPERT TO THE PERMANENT BUREAU AND THE CHAIR OF THE DRAFTING GROUP ("MARCH 2001 DRAFT")

Article 4 Determination of place of relevant securities intermediary

(1) In this Convention, the place of the relevant securities intermediary means the place where the securities account is maintained.

(2) For the purposes of this Convention, the securities account is maintained at the place of the office of the relevant securities intermediary agreed between the account holder and the securities intermediary, provided that the securities intermediary treats the securities account as being maintained at that office for [a regulatory, accounting or internal reporting purpose] [regulatory, accounting or internal reporting purposes].

(3) If the place where the securities account is maintained is not determined under paragraph (2), the factors that may be considered in determining the place where the securities account is maintained include the following:

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

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

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

(d) the terms of account statements or other reports prepared by the relevant securities 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.

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

(a) the place where the technology supporting the bookkeeping or data processing for the securities account is located;

(b) the place where certificates representing or evidencing securities are located;

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

(d) the place where the issuer of the securities is organised or incorporated or has its statutory seat or registered office; or

(e) the place where any intermediary other than the relevant securities intermediary is located.