SPHERE OF APPLICATION OF THE UNIDROIT CONVENTION ON SUBSTANTIVE RULES FOR INTERMEDIATED SECURITIES AND FUTURE WORK BY UNIDROIT ON A LEGISLATIVE GUIDE FOR EMERGING FINANCIAL MARKETS

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A. The UNIDROIT Convention on Substantive Rules for Intermediated Securities

The UNIDROIT Convention on Substantive Rules for Intermediated Securities (also known as "Geneva Securities Convention" and referred to hereafter as "the Convention") was adopted at a diplomatic conference in Geneva on 9 October 2009. The main purpose of the Convention is to offer harmonized transnational rules for the purpose of reducing the legal risks associated with the holding of securities through intermediaries.

Sphere of application

The sphere of application of several international conventions in the commercial law field is often defined by a general description of the subject matter covered and a reference to some element of internationality.[2]

Article 2 does not follow this classical approach because the high level of interdependency in today's financial markets makes a distinction between "domestic" and "international "transactions unworkable.

Instead, the Convention is intended to be part of the substantive law of a Contracting State. Therefore, the Convention will be applied in such a State on the matters dealt with in the Convention to the extent that the substantive law of that State is the applicable law for such matters. [3]

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[1] Secretary-General, UNIDROIT.

[2] For example, Article 1(a) of the Receivables Convention: "This Convention applies to: *(a)* Assignments of international receivables and to international assignments of receivables as defined in this chapter, if, at the time of conclusion of the contract of assignment, the assignor is located in a Contracting State.

[3] Article 2 provides that the Convention applies whenever "(a) the applicable conflict of laws rules designates the law in force in a Contracting State as the applicable law; or (b) the circumstances do not lead to the application of any law other than the law in force in a Contracting State."

It follows from the above that whenever the law of a Contracting State is the applicable law on matters covered by the Convention, the provisions of the Convention, rather than State's other laws on the same matters, shall apply.

What are the matters dealt with in the Convention? They are essentially the following:

- Rights of accounts holders in respect of intermediated securities and their effects as regards third parties, and the means for acquiring, transferring and pledging rights in intermediated securities;
- Priority among competing interests and interests granted by an intermediary;
- Rights and duties of securities intermediaries vis-à-vis the account holders, other intermediaries and third parties (e.g. insolvency administrators);
- Rules intended to ensure the integrity of the intermediated holding system (these include provisions on: prohibition of upper-tier attachment, holding or availability of sufficient securities, allocation of securities to account holders' rights, loss sharing in case of insolvency of the intermediary, insolvency of system operator or participant, obligations and liability of intermediaries).

Notion of "intermediated securities"

"Intermediated securities", together with "securities account" and "intermediary", sets the field in which the Convention primarily applies. Thus, "intermediated securities" is the central notion for the Convention. This term refers to rights which arise from the credit of securities to a securities account, and which, in accordance with the non-Convention law[4], may include direct ownership or joint ownership rights in the underlying securities or some other proprietary interests or contractual rights in respect of the securities.

As defined in the Convention,[5] "intermediated securities" mean any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of the Convention and which have in fact been credited to a securities account or rights or interests in securities resulting from the credit of

[4] Defined in Article 1(m) of the Geneva Securities Convention as "the the law in force in [a] Contracting State [...] other than the provisions of this Convention".
[5] Geneva Securities Convention, Article 1(a) and (b).

securities to a securities account. The application of this Convention therefore requires that at least one intermediary is involved in the holding of the securities in question.

A "securities account" is an account to which securities may be credited or debited and which is maintained by an "intermediary", that is, a person who in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity".[6] In practice, intermediaries are entities such as banks, brokers, central banks and similar persons which maintain securities accounts for their clients. From a purely functional perspective, the definition does not set any limit as to who could be an intermediary, and the term includes both regulated and unregulated entities. However, the definition expressly includes Central Securities Depositories (CSDs) among possible "intermediaries" for the purposes of the Convention.[7]

To qualify as "securities", financial assets must, therefore, meet two functional criteria. First, they must be capable of being credited to securities accounts maintained by an intermediary. Secondly, they must be capable of being acquired and disposed of in accordance with the provisions of the Convention, mostly Articles 11[8] and 12.[9]

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[6] Geneva Securities Convention, Article 1(c) and (d).

[7] This specification was inserted at the occasion of the fourth session of the UNIDROIT Committee of Governmental Experts (CGE) that prepared the draft of the convention with a view to confirming the inclusion of securities accounts held by CSDs in the scope of the Convention (see UNIDROIT 2007 — Study LXXVIII — Doc. 95, section 13 *et seq.*). The background was that some negotiating States had raised doubts regarding the status of CSDs as intermediaries, mainly because of their special role and relationship with the issuer. The insertion now clarifies that CSDs are intermediaries under the Convention. However, CSDs are intermediaries only in relation to their participants (clients) but not in relation to the issuer, i.e., CSD and issuer are not tied to each other by means of a securities account to which securities are credited and debited

[8] The main methods for the acquisition and disposition of intermediated securities or of any interest in intermediated securities under the Convention are the credit or debit of those securities to the account holder's securities account ("book entry"). Article 11 paragraph 2 declares further that no further step is necessary to render the acquisition effective against third parties

[9] Article 12 deals with acquisitions and dispositions of intermediated securities by three methods other than by credits and debits. These are: (a) an account holder may grant an interest in intermediated securities to the relevant intermediary by entering into an agreement with that intermediary, and no further step is necessary to make that interest effective against third parties; (b) an account holder may grant an interest in intermediated securities to another person by entering into an agreement with that person and by having a designating entry apply to those intermediated securities in its securities account, and no further step is necessary to make that interest effective against third parties; and (c) an account holder may grant an interest in

Intermediated securities within the meaning of the Convention are created when certificated or uncertificated securities are brought into the intermediated holding system and are credited to a securities account. They are extinguished when (if possible) securities are withdrawn from the intermediated system to be held directly by an investor.

The Convention does not provide a "laundry list" of securities qualifying under this definition. As long as the two above-mentioned functional criteria are satisfied, the definition includes bearer and registered securities. It also includes securities represented by individual certificates, those by a single (global) certificate and purely dematerialised securities.

It is clear from the above that the definition of intermediated securities excludes certificated securities held physically and directly by an investor as well as securities registered directly with an issuer in the name of investors.

For the purpose of the definition, it is not necessary that securities are actually credited to the securities account at any given time. A securities account may be opened in anticipation of some future transaction. The definition of securities accounts applies *inter alia* to accounts maintained:

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

However, securities recorded in accounts maintained directly by issuers in the name of their shareholders or bondholders are not "securities accounts", or to issuer accounts (or

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

registers) maintained by central securities depositories or other persons such as transfer agents on behalf of issuers.

Excluded functions

One important limitation to the sphere of application is that the Convention does *not* apply to the functions of creation, recording or reconciliation of securities, vis-à-vis the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar. [10]

Coupled with the definition of "intermediary", in Article 1(d) and of "account holder" in Article 1(e),[11] Article 6 further refines the scope of application of the Convention by excluding certain functions that are not characteristic of the activities of an intermediary (i.e. maintaining securities accounts, making credits, debits or designating entries to securities accounts, entering into control agreements and enabling account holders to receive and exercise their rights).

Of particular significance in the present context is the exclusion of the functions of creation and issuance of securities from the scope of the Convention. This exclusion is in line with another important limitation to the scope of application of the Convention, which is provided for in Article 8, namely that the Convention does not cover "corporate law" matters. Indeed, Article 8 clarifies that, subject to the obligation for Contracting State to recognise the so-called "nominee-holding structure" (and consequently also arrangements such as "split-voting")[12] the Convention does not affect any right of the account holder against the issuer of the securities. In particular, the Convention does not determine whom the issuer is required to recognise as the

[10] Geneva Securities Convention, Article 6.
[11] Defined in Article 1(e) of the Geneva Securities Convention, as "a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary)".
[12] Geneva Securities Convention, Article 29(2): "[..]the law of a Contracting State shall recognise the holding of such securities by a person acting in its own name on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways in relation to different parts of a holding of securities of the same description; but this Convention does not determine the conditions under which such a person is authorised to exercise such rights."

shareholder, bondholder or other person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose. [13]

The word "issuer" of the securities is not defined in the Convention. For traditional investment securities such as shares and bonds, defining the issuer is usually not difficult, but for structured financial products such as asset-backed securities, it is not always easy to determine who the issuer is. Similarly, "holder" of the securities is not defined in this Convention. It includes shareholders, bondholders and any other holders of securities.

Article 8 must be read in conjunction with other provisions, in particular Article 9, which sets out the rights acquired by the account holder under the Convention through the credit of the securities to its account. [14] Thus, for instance, Article 8(1) is not intended to deny or otherwise limit the right resulting from the credit under Article 9(1)(a) and applies to the matters with respect to the relationship between the account holder and the issuer which are beyond what is spelled out in Article 9(1)(a).

By the same token, neither is Article 8(2) an exception to Article 9(1)(a), since it t does not address what the account holder is entitled to receive but only whom the issuer is required to recognise.

[13] Geneva Securities Convention, Article 8(2).

[14] These, pursuant to Article 9(1) of the Geneva Securities Convention, include:

"(a) the right to receive and exercise any rights attached to the securities, including dividends, other distributions and voting rights:(i) if the account holder is not an intermediary or is an intermediary acting for its own account; and (ii) in any other case, if so provided by the non-Convention law;

"(b) the right to effect a disposition under Article 11 or grant an interest under Article 12;

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

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

B. Future work by UNIDROIT on a Legislative Guide for Emerging Financial Markets

At its 87th session, in 2007, the UNIDROIT Governing Council examined the triennial Work Programme of the Institute on the basis of the Secretariat's survey with Governments, international Organisations and industry as well as with the Institute's correspondents. Following an in-depth discussion, the Governing Council recommended, *inter alia*, to the General Assembly to include in the Work Programme for the triennium 2009-2011, "work on an instrument on netting in financial services, a legislative guide on principles and rules capable of enhancing trading in securities in emerging markets and, resources permitting and possibly included in that guide, rules facilitating convergence of national investor classification systems."

It had been assumed, at that time, that the Convention on Substantive Rules Regarding Intermediated Securities, then still under negotiation, would have been completed before the end of 2008. However, the diplomatic Conference held in Geneva from 1 to 12 September 2008 decided that an Official Commentary to the Convention should be prepared and that a second session should be convened in 2009 to finalise and adopt the Convention.

As a result of that decision, the UNIDROIT General Assembly, at its 63rd session, in 2008, agreed to postpone the inclusion of new topics in the organisation's Work Programme and to assign the highest priority to the finalisation of the then outstanding projects, namely, the draft Convention on intermediated securities, the additional chapters of the UNIDROIT Principles of International Commercial Contracts currently under preparation and the Space Protocol to the Cape Town Convention. Following the successful completion of the work on the Convention, and in the light of a reiteration by the Governing Council of the importance attached to the topic, the UNIDROIT General Assembly, at its 65th session, in 2009, firmly included work on a "Legislative Guide on principles and rules capable of enhancing trading in securities in emerging markets" in the current Work Programme of UNIDROIT.

As a first step, the UNIDROIT Secretariat has started preparing an Accession Kit to the Convention. The purpose of the Accession Kit is to provide advice for countries that ratify the Convention on how best to incorporate the Convention and integrate it into their

domestic legal systems. It is a fact that the Convention makes numerous references to the non-convention law. Here are a few examples:

- Article 7 (1), authorizes Contracting States to declare that a person other than the relevant intermediary is responsible for the performance of a function or functions (but not all functions) of the relevant intermediary under this Convention;
- Article 9(3) defers to the non-Convention law on any limits on security interests, or a limited interest other than a security interest, rights acquired by the credit of securities to a securities account;
- It is also the non-Convention law, pursuant to Article 16 (and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system) that determines whether and in what circumstances a debit, credit, designating entry or removal of a designating entry is invalid, is liable to be reversed or may be subject to a condition and the consequences thereof;
- Article 22(3) authorises Contracting States to declare that under its domestic law an attachment of intermediated securities of an account holder made against or so as to affect a person other than the relevant intermediary has effect also against the relevant intermediary;
- Furthermore, it is non-Convention law, under Article 24(3), that sets the time within which an intermediary must replenish a shortfall in securities and, more generally, under Article 24(4), it is the non-Convention law that provided the method for the intermediary to ensure the permanent sufficiency of securities of the same description as are credited to its clients or to itself;

Article 28 gives broad freedom to non-Convention law (and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system) to specify the obligations of an intermediary under the Convention and to establish the intermediary's liability for their breach.

In addition to these specific references to non-Convention law, the Convention assumes the existence of provisions on a number of areas which directly or indirectly are outside the scope of the convention, either because the Convention itself declares that it does not

govern a particular matter or that its provisions do not "affect" the applicable law on a particular subject, or because the Convention authorises Contracting States to exclude certain provisions by declaration. Some significant examples of the first situation have been mentioned earlier (e.g. Article 6 on creation, issuance and recording of securities; Article 8 on "corporate law matters"); other examples of referral to law other than the Convention include: applicable rules of law on non-consensual security interests[15] and their relative priority;[16] rights and liabilities of the "non-innocent" acquirer of securities;[17] possible additional rights or powers of a collateral taker or additional obligations of a collateral provider above and beyond those set forth in the Convention;[18] and the priority interest pre-existing the entry onto force of the Convention in a contracting State.[19]

Lastly, the Convention contains a complex system of opt-out declarations,[20] some of which may include entire chapters, such as the opt-out declaration concerning the provisions on collateral transactions.[21] The Convention also allows Contracting States to further shape its application though a number of opt-in declarations, including some that are primarily intended to enhance transparency in the application of the Convention.[22]

Against this background, the Governing Council agreed that it would be useful to prepare a UNIDROIT document explaining how to address those issues which the Convention itself refrained from addressing or allowed Contracting States to provide for otherwise, and how to fill these gaps.

The UNIDROIT Governing Council also anticipates that the work done in the preparation of the Accession Kit to the Convention, by canvassing all the other areas of law that affect or support the development of a modern financial market, will lay the ground for the work

[15] Geneva Securities Convention, Article 12(8).
[16] Geneva Securities Convention, Article 19(7).
[17] Geneva Securities Convention, Article 18(4).
[18] Geneva Securities Convention, Article 31(2).
[19] Geneva Securities Convention, Article 39.
[20] See, for instance, Geneva Securities Convention, Articles 5, 12(5)(a)-(c), 12(6), 12(7), 25(5), and 36(2).
[21] See, for instance, Geneva Securities Convention, Article 38.
[22] See, for instance, Geneva Securities Convention, Articles 1(n)(iii), 1(o)(iii), 7, 12(5)(a), 19(7), 22(3), and 39(2).

on the broad legislative guide to principles and rules capable of enhancing trading in securities in emerging markets.

A number of such adjacent areas of the law had been tentatively identified at an early stage of consideration of this project.[23]

[23] Such as "(a) Nature and types of securities, including fungible and dematerialised securities; (b) Transactional structure of bond issues; (c) Transactional structure of share issues (IPOs); (d) Organisational and transactional provisions to enhance liquidity on secondary markets; (e) General contract law and special rules relating to trading in securities; (f) Legal issues relating to trading and settlement; (g) Legal issues relating to collateralised transactions; (h) Regulatory framework" (see http://www.unidroit.org/english/workprogramme/study078/main.htm).