



# UNIDROIT Study Group on **Securities held with an Intermediary**

## ***G30 Plan of Action: UNIDROIT contribution to recommendations on legal certainty***

*London, May 13, 2003*

### **Introduction**

The G30 2003 *Plan of Action for Global Clearing and Settlement* identifies, among issues requiring urgent attention, a number of points of legal uncertainty regarding securities held indirectly through intermediaries<sup>1</sup>. Similar concerns have been expressed by the Giovannini Group<sup>2</sup>, CPSS/IOSCO<sup>3</sup> and the European Securities Forum<sup>4</sup>.

*Points of legal uncertainty  
identified as concerns by  
G30 and others*

Substantial work has already been undertaken to address these concerns. For example, the EU Collateral and Settlement Finality Directives have harmonized key aspects of the laws of EU member states relevant to securities settlement systems and indirectly held securities, and the concerns relating to conflict of laws issues have been addressed by the December 2002 Hague "PRIMA" Convention<sup>5</sup>.

*Existing measures to ad-  
dress these concerns*

These initiatives have achieved important progress, but are not of themselves enough fully to address the concerns identified by the G30. EU Directives operate only on a regional level; and while it is hoped that the Hague Convention will in due course extend worldwide, it is by its nature confined to

*Further work required to  
address the concerns in  
full*

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<sup>1</sup> See in particular recommendation 15 and, in part, recommendation 13.

<sup>2</sup> Second report on EU Clearing and Settlement Arrangements, April 2003, especially the discussion of the removal of Barrier 13.

<sup>3</sup> Recommendations for Securities Settlement Systems (2001), especially recommendations 1, 12 and 19.

<sup>4</sup> ESF Call for Action on integration of clearing and settlement in Europe, May 2003, especially paragraph 2.4.

<sup>5</sup> See the Final Act of the 19<sup>th</sup> session of the Hague Conference on Private International Law, incorporating the text of a Convention on the law applicable to certain rights in respect of securities held with an intermediary.

conflict of laws issues. A clear identification of the applicable law is a huge step forward, but the law identified may be unsatisfactory when measured against the standards suggested by the G30. Moreover, individual laws which operate satisfactorily in isolation may fail to combine effectively in the context of cross-border holding and settlement systems.

There is therefore a clear need for a forum in which -

*Need for a forum*

- the issues of substantive law that are fundamental to the achievement of legally sound and robust arrangements for indirect holding and clearing and settlement can be identified and discussed;
- agreement can be reached on any issues which demand uniform rules of substantive law; and
- the uniform rules thus identified can be drafted.

UNIDROIT, as a global legal organization with 59 Member Countries, whose laws include all the key systems of financial law around the world, is ideally placed to provide such a forum. Indeed, work in this area is already well under way. In accordance with the clearly expressed preferences of Member States, UNIDROIT current projects include a project regarding securities held with an intermediary. A restricted Study Group, comprising experts from a number of countries, many of whom were also closely involved in the development of the Hague Convention, was constituted in 2002.

*UNIDROIT may provide the forum; work already in progress*

The Study Group held its first session in September 2002. It concluded that it was indeed important to consider the modernization and harmonization of key aspects of substantive law relevant to the cross-border holding and transfer of securities held through intermediaries. It divided the issues into two categories –

*First session of UNIDROIT Restricted Study Group (September 2002)*

- The first category was that of issues relating to the key features which a structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, taking account in particular of objectives of investor protection and efficiency. The study group termed these issues of **internal soundness**.
- The second category was that of issues affecting the ability of different legal systems to connect successfully where securities are held or transferred across national borders. If the rules of two systems of law, though each achieving internal soundness, produce an unclear or unsatisfactory result in combination, this raises issues which the study group termed issues of **compatibility**.

It was agreed that further discussion and study were required, in the light of more detailed consideration of the current position under a number of legal systems. To that end, the Study Group agreed to meet again in March 2003 and to undertake fact finding initiatives in the interim. Fact finding meetings were in the event held with groups of experts in the United Kingdom and France in the early part of 2003.

*Further work 2002/2003*

The Study Group developed and refined its thinking further at its March 2003 meeting. It focussed first on the criteria that should govern whether a particular matter needs to be governed by a harmonized rule. It concluded that a rigorous approach should be adopted, and that a harmonized rule should be regarded as appropriate if, but only if, it is clearly required for the reduction of legal or systemic risk or the promotion of market efficiency. This approach recognizes that, however desirable it is in principle to achieve harmonized rules, this is in practice a complex and difficult process requiring both technical and political consensus. The difficulty of achieving this, particularly within a reasonable timeframe, strongly supports a restrictive approach to the scope of harmonization.

*March 2003 meeting of Study Group; criteria for harmonized rules*

Confusion can easily arise from the different traditions and conceptual frameworks of different systems of law. For this reason the Study Group concluded that it should adopt a functional approach – that is, one which uses language which is as neutral as possible and formulates rules by reference to their results. It drew in this respect on the experience of the Hague Convention, where it was found unexpectedly difficult to use even common concepts such as “property” or “proprietary” interest in a manner which would be understood in the same way under all laws. The Hague Convention therefore avoided such terms and used instead more neutral language such as “effects against third parties”.

*Functional/result-oriented approach*

A key element of the Study Group’s approach is a recognition of the central position of book entry accounts in modern indirect holding and transfer systems. Parties dealing in securities held with an intermediary need to be sure that a credit of securities to their account represents a good and effective interest. Equally, an intermediary making such a credit will often itself need the assurance that a corresponding credit in a book entry account held with a higher tier intermediary represents a good and effective interest.

*Centrality of book-entry accounts ...*

The importance of the security of book entry interests is particularly marked in the common situation where linked transfers of interests are taking place through different intermedi-

*... especially in cross-border transfers*

aries and settlement systems, operating under different laws. Any doubt about the effectiveness of an interest represented by a book entry credit, or about the effectiveness and finality of a transfer made through book entry debits and credits, would give rise to damaging uncertainty and systemic risk. For the same reason, intermediaries and operators of settlement systems need to be confident that they can look to, and accept instructions from, the investors recorded in their own book entry accounts and are not exposed to adverse claims or attempted interference from third parties.

In the light of these objectives, the Study Group has provisionally concluded that uniform rules are desirable in relation to –

*Areas for uniform harmonized rules*

- the effects against the intermediary and third parties of the credit of securities to a securities account;
- the protection of an intermediary operating securities accounts from claims of or interference by parties other than its account holder (exclusion of “*upper-tier attachment*”);
- the procedure for transfer of securities credited to a securities account and in particular the need for, and sufficiency of, book entry credits and debits to effect such a transfer;
- priorities between competing dispositions (in particular, an appropriate *bona fide* acquirer rule);
- the finality of transfers of book entry securities and the irrevocability of instructions for such transfers.

Because book entry accounts have become the universal medium for the holding and transfer of securities in the modern indirect holding system, the Study Group regards the above issues as issues of compatibility requiring a uniform rule. It has also considered other issues which go to internal soundness and which, because they form part of the basic underpinning of book entry accounts, may also require uniformity as to the result, if not necessarily as to the manner of attainment. Such issues include –

*Other criteria of soundness*

- the protection of property representing account holders’ interests from the claims of general creditors of the intermediary in an insolvency of the intermediary;
- the consequences of any insufficiency of assets held by the intermediary to satisfy the rights of account holders (the Study Group view being that the appropriate rule

should be a *pro rata* abatement of the account holders' claims).

Further points on which the Study Group has yet to reach a concluded view as to the need for a uniform rule include –

*Other possible harmonized rules*

- the perfection of security interests: whether there should be a uniform procedure for perfecting security interests in book entry securities created otherwise than by transfer to a new book entry account;
- definition of terms of such as "*securities*".

In relation to some other issues, the Study Group inclines to the view that a uniform rule is not necessary under the standards suggested above. It has however considered whether, where issues of this kind are relevant to the standard of internal soundness, there should be a "*benchmark*" instrument describing minimum standards that should be applied.

*Use of "benchmark" standards where uniformity not required ?*

The Study Group is working on a position paper summarizing and explaining its thinking, which it is proposed to issue in the summer of 2003. The purpose of the position paper will be to facilitate widespread discussion of the issues among all interested parties in preparation for a further meeting of the Study Group in November 2003. Following that meeting it is expected that a decision will be taken on the form and broad content of the instruments required. If it were agreed that a convention is needed, one could expect the preparation of a text for presentation to member State governments to take a minimum of around two years.

*Study Group position paper to be issued shortly; future steps*

The complexity of the subject matter, and the crucial importance of understanding how holding and settlement systems operate in practice, make it essential to ensure close cooperation with industry and other interested parties. The experience of developing the Hague Convention suggests that this is likely to be a time-consuming process, but one that would greatly enhance the quality of the final product and also greatly facilitate its attainment.

*Importance of close cooperation with industry ...*

Just as the involvement of industry is crucial, so too is the support of national and international policy makers. It is therefore timely that the G30 has stressed the importance of these issues in its Plan of Action.

*... and of support of national and international policy makers, including G30*