LAW COMMISSION

INTERIM ADVICE

IN RELATION TO

THE EU LEGAL CERTAINTY GROUP ADVICE

AND

THE UNIDROIT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

PART 1
PURPOSE OF THE ADVICE

INTRODUCTION

1.1 The purpose of the Interim Advice is to assist Her Majesty's Treasury in determining the position that the UK Government should take in relation to the European Commission's initiative to remove the legal barriers to the cross-border clearing and settlement of investment securities within the EU.

1.2 This Interim Advice contains a detailed review of:

(1) The written advice given by the Legal Certainty Group to the European Commission in respect of this initiative;[1] and

(2) The draft UNIDROIT Convention on Substantive Rules Regarding Intermediated Securities (the "Convention").

1.3 As is described below, adoption of the Convention has been mooted as offering the best route for establishing a minimum level of harmonisation of Member States' laws in relation to intermediated securities. If the Treasury is minded to encourage the European Union to pursue this route, we should take steps to ensure that the draft Convention accommodates the UK's business and legal requirements as fully as possible.

1.4 This analysis is intended to assist the Treasury in giving instructions to its delegates at the next meetings of the UNIDROIT Committee of Governmental Experts in November 2006. The time-scale has meant that it has not been possible to hold a formal consultation before submitting the Interim Advice to the Treasury; however, the analysis is based on the views expressed in the seminar papers and at the workshops held by the Law Commission earlier this year.

1.5 The Interim Advice is being placed on our web-site and circulated to consultees so that interested parties can submit further reflections, which will be passed to the Treasury. We consider it likely that the Interim Advice will be followed by further advice to the Treasury in response to subsequent drafts of the Convention and to developments in the EU initiative generally.

Content of the Advice

1.6 The Advice is set out as follows:

(1) A brief summary of the background to the Law Commission's Project and the current state of play.

(2) The Law Commission's provisional conclusions regarding a harmonised framework for the treatment of intermediated securities. These conclusions have been the subject of discussion in seminars with lawyers, academics and industry representatives but have not been subjected to a formal consultation process.

(3) An analysis of the Convention and comparison with the current position of the EU Legal Certainty Group (the "LCG").

(4) A mark-up of the latest draft of the Convention incorporating our proposed amendments.

BACKGROUND TO THE LAW COMMISSION PROJECT

1.7 Before undertaking a comparative analysis of the Convention and the advice of the LCG, it may be helpful to put into context the Law Commission's project by summarising the three existing legislative initiatives in this area of the law.

UNIDROIT Convention

1.8 UNIDROIT has been working towards establishing an international convention on substantive rules regarding intermediated securities since 2001. The UNIDROIT membership comprises 60 states, including every Member State of the European Union except Lithuania.

1.9 As is described in more detail below, the UNIDROIT project closely mirrors the work that is being undertaken by the LCG. Many of the EU delegates are also members of the LCG. The Convention is now at an advanced stage of drafting and a plenary session of UNIDROIT has been scheduled for early November 2006 in the hope of finalising it.

FMLC Report

1.10 In 2002, the Financial Markets Law Committee (the "FMLC") invited Professor Sir Roy Goode to chair a working group of experts to address the legal risk affecting the intermediated holding of investment securities in the UK. This legal risk arose from the failure of English law to keep pace with certain operational changes in the market. These changes included the pooling of securities into omnibus accounts, the complex intermediation of securities holding and the computerisation of book-entry ownership and transfer. The working group was asked to draft detailed proposals for domestic legislation.

1.11 The working group published its report in July 2004. The report found that although English law in this area was basically sound, the relevant legal principles and rules governing the treatment of intermediated securities were not readily accessible. In addition, some anomalies in the law needed to be removed to accommodate market practice. The FMLC Report recommended that legislation be passed to remedy these deficiencies and set out a series of principles for the drafting of an investment securities statute.

[1] This advice is available at http://ec.europa.eu/internal_market/financial-markets/docs/certainty/advice_final_en.pdf.

The EU Initiative

1.12 In November 2001, the Giovannini Group published a report identifying the operational, tax and legal barriers to efficient cross-border clearing and settlement of securities.[2] Of the 15 barriers identified in the report, three related to legal uncertainty.[3] In its second report, published in April 2003, the Giovannini Group identified the absence of an EU-wide framework for the ownership, transfer and pledge of securities held through an intermediary as the most important legal barrier. The report highlighted that differences in the legal treatment of indirectly held – or intermediated – securities by Member States contributed to inefficiencies and additional costs in cross-border clearing and settlement.

1.13 In 2004, the European Commission issued a Communication in which it expressed its intention to appoint a group of legal experts to address the need for a legal framework for intermediated securities. In early 2005, the Legal Certainty Group (the "LCG") was formed. The LCG is chaired by the European Commission and is composed of around 30 legal experts drawn from academia, the public and the private sectors, whose membership is personal, and not representative of their respective Member States. The LCG's mandate is to undertake in-depth legal analysis of the following issues:

(1) The absence of an EU-wide framework for the treatment of interests in securities held with an intermediary;

(2) The differences in national legal provisions affecting corporate action processing, such as discrepancies in Member States' laws as to the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g. for the payment of dividends;

(3) The restrictions relating to the issuer's ability to choose the location of its securities.

THE LCG ADVICE

1.14 Since its formation, the LCG has had five plenary meetings and conducted a comprehensive survey of the legal treatment of intermediated securities in each of the Member States. On 28 July 2006, the LCG formally communicated to the European Commission its written advice (the "LCG Advice) on the three issues referred to above. The LCG concluded that:

(1) legislation was necessary to provide a minimum level of harmonisation of Member States' laws in relation to the legal effect of book entries made on securities accounts.

[2] The Giovannini Report on Cross-Border Clearing and Settlement Arrangements in the European Union (November 2001).

[3] The legal barriers related to netting, conflicts of laws and substantive law.

(2) a proposed solution regarding the differences in national laws affecting corporate actions should wait until the conclusion of other EU investigations and the finalisation of proposals for the directive on shareholders' voting rights.

(3) restrictions did exist in relation to an issuer's ability to choose the location of its securities but that the matter required further study before specific proposals could be made.

1.15 In addition to recommending legislation, the LCG Advice set out, in fairly general terms, a number of core propositions that the new legislation should contain. These propositions are broadly consistent with the position taken in the current draft of the Convention. Later in this Advice, we analyse the differences between the LCG Advice and the Convention.

1.16 While the LCG Advice held back from formally recommending what legislative form should be adopted to implement a common legal framework, the LCG Advice did note that:

> …if the draft UNIDROIT Convention, when it has been negotiated, matches the new legislation described here, its ratification will be preferable to any parallel but separate Community instrument.

1.17 We understand that members of the LCG have strongly endorsed the adoption of the Convention as the best way of proceeding towards harmonisation within the EU. Ratifying the Convention has the considerable advantage of creating a legal framework that is not only compatible between Member States but also internationally with other contracting states to the Convention.

1.18 It is quite likely that the Convention will not be finalised in November 2006 but will require another plenary session in the first half of next year. Once finalised, the Convention will then be sent to the UNIDROIT Council for approval prior to ratification by the contracting states.

PART 2
LAW COMMISSION PROVISIONAL CONCLUSIONS

2.1 We set out below a summary of the preliminary conclusions reached so far in our project. These conclusions address legal issues that were identified in the early stages of the project as being fundamental to the creation of a common legal framework for the ownership and transfer of intermediated securities. They are listed in the order that they were discussed in the public seminars.

Protection from an Intermediary's creditors[1]

2.2 The protection of an account holder's interest in securities from the claims of its intermediary's creditors is at the core of the relationship between account holder and intermediary. To permit other creditors to have an equal claim to securities that the intermediary holds on behalf of its customers would distort the economic realities of this relationship. Accordingly, once intermediated securities have been credited to an account maintained by an intermediary for its account holders, the securities should not be subject to claims of the intermediary's other creditors.

2.3 Different legal systems have developed various means of ensuring that the commingling of customer securities in a pooled account does not affect the availability of this protection against creditors. While many systems prohibit the commingling of customer and intermediary assets, this segregation should not be a prerequisite for protection against creditors in a harmonised legal framework.

2.4 The protection granted by the legal framework rules should take effect, at the latest, upon the crediting of the account holder's account. This protection is without prejudice to earlier and additional rights that an account holder may have under domestic law to the extent that such rights do not conflict with the legal framework rules.

The allocation of losses[2]

2.5 Potential losses arising from settlement failure, operational error and fraud can occur in all systems. If the intermediary is unable or not obliged to remedy the potential loss, it becomes an actual loss borne by one or more account holders. How intermediated holding systems account for this potential loss tends to be a function of how they track dispositions in and out of accounts. Systems that match every corresponding debit and credit can reduce the risk of account imbalances (shortfalls) existing by automatically allocating the potential loss to a particular account holder. By contrast, non-matching systems permit shortfalls to exist and thereby only allocate a potential loss to account holders once it has become an actual loss. It is these non-matching systems that currently provide for methods of risk distribution (for example, pro rata sharing) between account holders in a pooled account.

[1] See paras 3.75-3.77 below for an analysis of the Convention's handling of this issue.

[2] See paras 3.103-3.120 below.

2.6 If an intermediary is unable or not obliged to replace securities or otherwise compensate an account holder as a result of an unauthorised transaction, the loss should be allocated between account holders in the same pooled account. We see no reason why this risk sharing should apply only to non-matching systems and not also to matching systems.

2.7 Subject to domestic law and with the consent of the intermediary,[3] an account holder should be able by arrangement with its intermediary to segregate its account and avoid sharing in shortfalls in other accounts. Segregation is effected by the intermediary opening a separate account with the issuer above or the upper tier intermediary in which the intermediary holds securities on behalf of the particular customer.

2.8 Where losses must be allocated between account holders, the loss should be shared in proportion to the size of each account holder's entitlement at the date of the commencement of insolvency of its intermediary (or of the relevant upper tier intermediary as the case may be). This method best reflects the common risk undertaken by account holders holding through one or more intermediaries.

2.9 Where an intermediary has commingled its own securities with those of its account holders, a loss arising from the intermediary's breach of duty should first be allocated to reduce those securities held for the intermediary's own account. If the intermediary is not responsible for the loss (for example, because it originated at a higher tier), it is arguable that the intermediary should only share the loss pro rata.

2.10 Where an intermediary has segregated its house securities in a separate account with an upper tier intermediary or issuer, a loss in its customer account should first be allocated to the intermediary's house account only if the loss arises from the intermediary's own breach of duty. If the intermediary is not responsible, it is difficult to justify the allocation of any of the loss to its segregated house securities.

Scope and enforceability of account holders' rights[4]

2.11 Some legal systems permit an investor to enforce rights not only against its immediate intermediary but also directly against the issuer. Others do not. There is no reason why direct and indirect enforcement systems cannot operate alongside each other within a harmonised legal framework. It would be unrealistic to expect to achieve consensus within the EU by favouring one over the other.

2.12 The valid credit of securities to an account should give the account holder a right to instruct its intermediary to transfer the securities or withdraw them from the account. The right is effective against third parties and enforceable against the account holder's own intermediary.

[3] Euroclear, for example, does not permit segregation of individual customer accounts.

[4] See paras 3.71-3.74 below.

2.13 The valid credit of securities to an account should give the account holder a right to receive the benefit of any corporate and economic rights in the underlying securities. This right is effective against third parties and is enforceable against the account holder's own intermediary. Subject to national law, the right may also be enforceable against the issuer.

2.14 National law must enable the effective exercise of rights enjoyed by account holders. Accordingly, rules that prevent split voting or that otherwise restrict an intermediary from exercising the corporate rights that attach to securities held in a pool should be prohibited in the case of publicly held securities.

2.15 Subject to the terms agreed with its account holder, an intermediary must take reasonable actions to obtain the corporate and economic benefits generated by the underlying securities and to comply with the account holder's instructions for the transfer or withdrawal of securities credited to the account holder's account.

No-look-through principle[5]

2.16 An account holder may enforce its rights in relation to the intermediated securities against its own intermediary. If national law permits, the rights are also enforceable directly against the issuer. An account holder cannot enforce its rights against a higher tier intermediary. This limitation removes the need for intermediaries to substantiate third party claims which purport to be based on rights in securities but which cannot easily be traced back to the securities that the intermediary holds.

2.17 An account holder should however be able to bring a claim against the issuer or an upper tier intermediary if it can demonstrate that the one or more intermediaries in between are disabled from bringing an effective action.

Upper tier attachment[6]

2.18 An account holder (and persons claiming through it, including creditors) should be prohibited from bringing an attachment order in relation to securities that are not credited to an account held by the account holder's intermediary. This is necessary to enhance market efficiency and to ensure a clear order of priorities between different tiers in a holding chain.

[5] See para 3.71 below.

[6] See paras 3.84-3.86 below.

The scope and level of duties owed by an intermediary

2.19 Most of the key duties owed by an intermediary are established from the perspective of account holder's rights enforceable against the intermediary. These include rights to receive corporate and economic benefits and to have the securities transferred. In addition, an intermediary is obliged to maintain a number and amount of securities that at least equals the aggregate number and amount of securities of the same description that are credited to securities accounts that it holds for account holders. This would permit the intermediary to count house securities towards satisfying its duty since any losses arising from the intermediary's breach of duty would first be allocated to these house securities.

2.20 If at any time an intermediary does not maintain sufficient securities to satisfy this duty, it should be obliged to promptly obtain additional securities.

2.21 The intermediary's duties should be subject to the terms of the account agreement with the exception of two obligations that cannot be contractually modified. These are the obligation to maintain sufficient securities (even if liability for breach of this duty can be limited) and the obligation to pass on economic distributions that it receives.

Instructions[7]

2.22 An intermediary may receive instructions from a range of person other than its account holders. In these circumstances, the intermediary needs clear rules as to whether it can act on, or ignore, instructions without incurring liability. Accordingly, we propose that an intermediary should act, and act only, on the instructions of its account holder in relation to securities that it holds for that account holder.

2.23 This duty should, however, be subject to the terms of any agreement between the parties, the rights of collateral takers, any order of court, any mandatory domestic rules and any settlement system rules.

Formalities of transfer[8]

2.24 Rights arising under a harmonised legal framework should be constituted and perfected by a credit to the account holder's account. No other formalities should be necessary.

2.25 A harmonised rule on transfers should not prevent a transfer being effected by other means under domestic law. The rule is intended to provide a certain means of transfer, not the only means of transfer.

2.26 The harmonised legal framework should be neutral as to whether the transfer of intermediated securities is an assignment of existing property or the extinction and creation of new rights by way of novation.

[7] See paras 3.87-3.89 below.

[8] See paras 3.18-3.25 below.

The moment at which interests in securities are acquired

2.27 By establishing the credit to an account as the constitutive act that creates rights in intermediated securities, it follows that an account holder should acquire rights in securities upon credit of the securities to its account.

2.28 The matter of what constitutes a valid credit to an account is currently left to national law and the rules of particular settlement systems. Domestic law may also give the transferee a proprietary interest at an earlier point in time (for example, upon acquisition of a proprietary interest by its intermediary). A credit is the core around which much of the harmonised system is based. Consequently there should be at least come common guidance as to what steps will constitute a credit.

Settlement finality[9]

2.29 A harmonised legal framework cannot attempt to provide an exhaustive list of circumstances in which transfers may be reversed or treated as ineffective. A sufficient level of settlement finality can be achieved by (1) disapplying insolvency rules that void transfers and netting retroactively; (2) preventing a transferor from revoking a transfer order after a certain point in the settlement cycle; and (3) protecting the finality of transfers to innocent purchasers.

2.30 The Settlement Finality Directive fulfils the first two of these objectives in relation to certain designated clearing and settlement systems. The question remains as to whether harmonised rules should deal with the effect of insolvency and the revocation of transfer orders in the case of transfers outside of designated settlement systems. Our provisional conclusion is that they should not.

Protection of an innocent purchaser[10]

2.31 In most cases, the difficulty in tracing securities through omnibus accounts and in systems that net transactions will provide an effective shield against most claimants. As a result of the difficulties in tracing pre-existing interests, as well as for reasons of efficiency, a person that holds securities through an intermediary should not expect the purchaser of the securities to investigate title to them. Accordingly, if an account holder's intermediary wrongfully transfers securities to a purchaser, the purchaser should take good title unless it has notice or strong suspicion of a violation of another's rights to those securities.

Collateral[11]

2.32 We have not yet held a public seminar to discuss the legal issues affecting the taking of security interests over intermediated securities. Generally, however, we support the approach taken by the Convention in relation to the methods necessary to perfect security. We also note that the Convention has replicated to a large degree the provisions of the Financial Collateral Directive in relation to the enforcement and re-use of book-entry financial collateral.

[9] See paras 3.56-3.68 below.

[10] See paras 3.39-3.55 below.

[11] See paras 3.121-3.125 below.

Preferred form of legislative instrument

2.33 The comparative analysis in the next section of this Advice will show that there are only relatively few issues on which the Convention, the LCG Advice and the Law Commission's own proposals are not generally aligned. Assuming that these differences can be resolved satisfactorily, we share the view of LCG members that ratification of the Convention will offer the best legislative means of removing the legal barriers to cross-border clearing and settlement systems within the EU. We believe that a shared legal framework with the United States, Japan and other significant capital markets jurisdictions is both achievable and greatly preferable to the existence of two (or more) parallel frameworks operating upon slightly different rules.

PART 3
THE CONVENTION: COMPARATIVE ANALYSIS AND COMMENTARY

Scope

The Convention

3.1 The scope of the Convention is broad. It applies to all shares, bonds or other financial instruments or financial assets (other than cash), which are capable of being credited to a securities account.[1] The securities account is an account maintained by an "intermediary", being a person who operates securities accounts in the course of a business or other regular activity for others.[2] Accordingly, while the Convention is not limited only to regulated financial intermediaries, non-business situations fall outside its scope.

3.2 Crucially, the Convention makes no distinction between domestic and cross-border ownership and transfer of securities but applies equally to both.

Legal Certainty Group

3.3 The LCG's position is generally consistent with the Convention on this issue. The LCG Advice adopts the wide meaning of securities attributed to that concept by EU law. It proposes that scope should not be restricted to ISIN[3] bearing securities or to listed securities but remain open-ended. All book-entries are covered, whether or not they relate to a transaction with a cross-border element.

3.4 The LCG also shares the view that the new legislation should apply to all intermediaries and not just to those that are subject to financial regulation. It does however propose the exclusion of business situations that are not intended to constitute intermediary relationships (for example, some inter-group relationships).

3.5 The LCG envisages that the new legislation should apply to central securities depositaries ('CSDs') only when acting in their capacity as account providers. Accounts operated by the CSDs for the sole purpose of establishing securities in book-entry form should not be covered by the legislation.

[1] Article 1(a).

[2] Article 1(b). There is a circularity in the definitions of "securities account" and "intermediary" that may need to be addressed in the final draft of the Convention.

[3] International Securities Identification Number. A unique international code which identifies a securities issue.

Law Commission Comments

DEFINITION OF SECURITIES

3.6 We agree that the scope of the legislation should apply to all financial instruments or financial assets (other than cash) that can be credited to an account maintained by an intermediary. The definition must be capable of accommodating changing market practice and financial innovation and we see no benefit in including some book-entry securities and excluding others. We note that the definitions either replicate or very closely resemble the definitions used by the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (the "Hague Convention"). It is clearly desirable that the scope of the Convention fits within the conflicts of laws regime established by the Hague Convention.

3.7 The Convention does not define the terms "financial instruments" or "financial assets".[4] Nor does it specify what characteristics a financial instrument or asset must possess in order for it to be capable of credit to an account. It is conceivable that the law in some states may prohibit certain financial assets from being credited to a securities account or may not recognise the credit for legal or policy reasons. Under the Hague Convention, the law governing the recipient's account will prevail to determine whether or not it is legally possible to record a financial asset as a book-entry. While this raises the potential risk of cross-border incompatibility, we suspect the risk in practice is small.

NON-BUSINESS ARRANGEMENTS

3.8 We consider the exclusion of non-business relationships from the scope of EU legislation to be entirely appropriate. The principal grounds for imposing a harmonised framework within the EU is to enhance market confidence and efficiency in cross-border clearing and settlement. Securities that are held in a non-business arrangement are unlikely to require, or benefit from, the changes needed to achieve this. Rules intended to accommodate computerised settlement and the administration of omnibus accounts will be of little relevance to securities held in a non-business arrangement such as a family trust. It would be overly invasive to require Member States to harmonise their laws in respect of non-business relationships that, by their nature, do not require conformity across the EU.

3.9 The LCG suggests a further carve-out in relation to business situations "that are not intended to constitute intermediary relationships". We agree that the credit of securities to an account in a business situation should, at most, give rise to a presumption of an intermediary relationship. This presumption could be rebutted by particular facts showing, for example, that the parties intend the custodian to have only a contractual duty of redelivery.

[4] "Financial instruments" are defined in the Financial Collateral Directive (2002/47/EC) in Article 2(1)(e).

3.10 In the alternative, or in addition, to a rebuttable presumption, the Convention could set out more clearly the circumstances in which an intermediary relationship arises. While difficult to encapsulate within a definition, Article 8 of the US Uniform Commercial Code manages to reach a satisfactory result by focusing on the intentions of the intermediary. It defines a securities account as one for which the person maintaining the account undertakes to treat the account holder as entitled to exercise the rights that comprise the financial asset credited to the account.[5]

3.11 A similar result could be achieved in the Convention by incorporating the notion of an intermediary's undertaking into a definition of what is meant by "maintaining" a securities account for others.

THE DEFINITION OF 'INTERMEDIARY' AND ITS IMPLICATIONS FOR CREST

3.12 The definition of an 'intermediary' is of particular importance to the UK settlement system as it determines whether operators such as CRESTco fall within the ambit of the Convention rules. Unlike most Continental central securities depositaries ("CSDs"), CRESTco is not recorded in the register of the issuer as holding securities on behalf of account holders but instead operates a register in which CRESTco's participants are named as direct holders. As such, CRESTco is keen to ensure that it is excluded from any definition of intermediary when acting in this merely record-keeping capacity.

3.13 In our opinion, the Convention definition of an intermediary as a person that "maintains securities accounts" does not unequivocally exclude CREST. The Explanatory Report on the Hague Convention (from which many of the Convention's definitions are derived) indicates that:

> In the context of a statutory operator of a securities transfer and settlement system, such as the United Kingdom CREST system…, the term 'securities account' is to be interpreted broadly to include any form of entitlements and transfers, whether or not denominated as an account by the operator.[6]

3.14 The LCG, however, clearly supports the view that such operations should be outside of the scope of the legislation and the definition in the Convention. One option to clarify this issue would be to adopt a declaration mechanism of the kind included in the Hague Convention.[7] Another would be to permit direct holding systems to opt-in to specific provisions of the Convention that applied equally to direct and indirect holding systems.

[5] UCC, §8-501(a).

[6] R Goode, H Kanda and K Kreuzer *Hague Securities Convention, Explanatory Report* (2005), p 32.

[7] Article 1(5) of the Hague Convention states: 'In relation to securities that are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may, at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention.

3.15 In addition to settling directly-held securities of UK listed companies, CREST issues CREST Depositary Interests ("CDIs") through a CREST nominee. CDIs represent underlying foreign listed securities and are settled within CREST in the same way as any other CREST eligible securities and are subject to the same rules.[8] As the nominee company[9] is the issuer of CDIs to CREST participants, the nominee is not technically an 'intermediary' in respect of the CDIs. However, the nominee issuer does hold the underlying securities (or intermediated securities, if the nominee holds through a higher tier intermediary) on trust for the recipients of the CDIs. As the CDIs represent entitlements to the underlying securities which are held in an account, it is quite possible that the holders of CDIs would be characterised as having rights in intermediated securities.

3.16 If the direct holding of CDIs is found to fall within the scope of the Convention, this could lead to CDIs being treated differently to other CREST eligible securities. While we do not believe there to be substantial differences between the Convention and the CREST Rules, some differences will clearly exist. CREST is concerned that these differences will cause uncertainty within CREST where no uncertainty currently exists.

3.17 Any attempt to specifically exclude CDIs from the ambit of the Convention is likely to meet with objections from other delegations. The most appropriate means of reducing or eliminating potential disparities in the treatment of CREST securities may therefore be to focus on the scope of Article 21 of the Convention. This Article gives the rules of a system operator precedence over some or all provisions of the Convention. UNIDROIT has yet to finalise whether system operator rules should prevail over (1) all provisions of the Convention, (2) only certain specific provisions or (3) only provisions that relate to the stability of the system or the finality of transactions effected through it. A complete carve-out for system operator rules will of course reduce the level of harmonisation within the EU by allowing each settlement system to continue to operate under its own rules. Only intermediated holdings outside of a operator based system would be subject to the Convention. We therefore favour a more selective approach (option 2 above) in which specific provisions of the Convention are disapplied in relation to systems with their own set of rules.

[8] Uncertificated Securities Regulations 2001, SI 2001/3755.

[9] CDIs are issued by CREST International Nominees Ltd. In addition, nominee companies owned by commercial registrars can issue Depositary Interests in CREST in respect of underlying foreign listed securities.

Transfer of Intermediated Securities

The Convention

3.18 Intermediated securities constitute rights that result from a credit to a securities account.[10] The Convention prescribes that no other steps are necessary to acquire these rights and for them to be effective against third parties. [11] Consequently a credit represents a simple and relatively certain means of transferring securities into a securities account. The Convention does not, however, prevent domestic law from providing earlier or additional means of acquiring interests in securities.[12]

3.19 Crucially, the Convention does not require that a credit be matched with a corresponding debit in order for it to be effective. The Convention does however permit legal systems to retain this matching requirement although a breach will not result in the credit becoming ineffective.[13]

Law Commission comments

3.20 The rights that arise upon a book-entry in favour of an account holder are constituted and de-constituted by crediting and debiting accounts. Extinguishing and creating rights in relation to fungible, intangible securities in this way has the equivalent effect to delivering a tangible asset from one person to another. It must be noted, however, that the simplicity of this method of 'transferring' intermediated securities belies the more complex issue of what constitutes an *effective* credit.

CREDIT TO AN ACCOUNT

3.21 An account holder receives no rights under the Convention until its intermediary has credited its account. This differs from the approach taken by the Uniform Commercial Code in the United States (the "UCC"). UCC Article 8 gives investors the rights associated with a credit once the securities have been 'accepted for credit'.[14] Accordingly, a customer can, for example, enforce its security entitlement against an intermediary as soon as the intermediary takes receipt of bearer certificates on the customer's behalf. In addition, UCC Article 8 contains a residual test that gives the customer the package of rights once its intermediary becomes 'obligated under other law, regulation, or rule' to credit the customer's account.[15] These rights can potentially arise even if the intermediary has yet to receive the financial assets that are to be credited to the account.[16]

[10] Article 1(f)

[11] Article 4(1) and (2).

[12] Article 4(6).

[13] Article 4(4).

[14] UCC, §8-501(b)(2).

[15] UCC, §8-501(b)(3).

[16] UCC, §8-501(c).

3.22 While the Convention relies exclusively on a credit as the source of an account holder's rights, it does not attempt to specify what accounting, record-keeping, or information transmission steps suffice to indicate that a credit has been properly made. This is left to domestic law, trade practices or agreement. UCC Article 8 also makes no attempt to define a credit. However, it has less need to do so; for the reasons described above, a customer is still likely to obtain a securities entitlement under Article 8 if a credit is not made or is incorrectly entered.

3.23 In light of the importance placed upon a credit by the Convention, we propose that at least a minimum level of harmonisation is introduced to enable account holders to ascertain what steps are will guarantee that a credit has been made. The current absence could easily lead to uncertainty. Some jurisdictions will, for example, require a credit to be made in strict compliance with the relevant system rules in order for the credit to be effective; in other jurisdictions it may suffice that a decision has been taken by the intermediary to credit the account and/or that the necessary processing has been initiated but not completed.[17]

MATCHING CREDITS AND DEBITS

3.24 Matching of a credit with a corresponding debit is another common prerequisite in a number of Continental systems (for example, Germany, France) to the effective transfer of intermediated securities. Matching reduces the risk of inflation, that is to say, the risk that there may be more credits to investors' accounts than there are underlying securities issued by the issuer.

3.25 The need to match transfers presents an additional step to attaining settlement finality and as such is a potential drag on the efficiency of settlement. Matching credits and debits can become difficult in clearing and settlement systems that operate multi-lateral netting.[18] English law does not require matching and the settlement of securities in CREST operates on a non-matching basis. It is important for the efficiency of settlement in the UK that we retain the current provision in the Convention that allows transfers to be effected without matching corresponding debits and credits.

Security Interests in Intermediated Securities

The Convention

3.26 The Convention sets out a two-step process for creating and perfecting a valid security interest in intermediated securities. The first step requires the collateral provider and the collateral taker to enter into a collateral agreement.[19] The only other step is to deliver the intermediated securities to the collateral taker. "Delivery" of the intermediated securities can be effected in one of four ways:

(1) By crediting the securities to the collateral taker's account.[20]

[17] See *Momm v Barclays Bank* [1977] 1 QB 790.

[18] Where the transfers of more than two counter-parties are netted.

[19] Article 5(1)(a).

[20] Article 5(2).

(2) By making a 'designating entry' in the securities account in favour of the collateral taker which has the effect of giving the collateral taker control (either negative or positive)[21] over the account or specific securities in it.[22]

(3) By the collateral taker and collateral provider entering into a control agreement with the intermediary or, if so permitted by domestic law, by them simply notifying the intermediary of the agreement.[23]

(4) Finally, if the collateral taker is the collateral giver's own intermediary maintaining an account on its behalf, the securities will be treated as being delivered to the intermediary.[24]

3.27 Only the first of these methods must be accepted by all contracting states as a means of delivery. A contracting state can choose through a declaration mechanism which of the remaining three methods will be treated as sufficient to deliver the securities under its domestic law.

3.28 The Convention permits contracting states to retain national differences in the granting of security in a number of other respects. Domestic law may, for example, exclude particular categories of collateral taker or provider from the Convention rules.[25] Domestic law also continues to determine (1) whether floating charges are permitted,[26] (2) the circumstances in which statutory liens arise and (3) the evidential requirements needed to satisfy the two-step process under the Convention.[27]

3.29 Security interests created in accordance with the Convention take priority over any security interests created and perfected under domestic law.[28] As between themselves, security interests created under the Convention rank in order of the time in which they become effective.[29]

[21] See paras 1.83-1.85 below.

[22] Article 5(3)(b).

[23] Article 5(3)(c).

[24] Article 5(3)(a).

[25] Article 5(5).

[26] Article 5(6)(a).

[27] Article 5(7)(a) and (b).

[28] Article 6(a).

[29] Article 6(b).

Law Commission comments

3.30 The LCG Advice makes no comment on the creation, perfection or enforcement of security interests over intermediated securities. This may be because the issues are dealt with, at least in general terms, by the Financial Collateral Directive[30] ("FCD"). The FCD confers advantages, for example in insolvency, to financial collateral arrangements between certain categories of collateral taker and provider and has been implemented in the UK by the Financial Collateral Arrangements (No 2) Regulations 2003 (FCAR).[31] It seems unlikely that the EU Member States could ratify the Convention if it was incompatible in any material respects with the FCD.

COMPARISON OF THE SCOPE OF THE CONVENTION AND THE FCD

3.31 While the Convention covers much of the territory already legislated by the FCD in relation to intermediated securities collateral, the scope of the Convention's rules is potentially wider both in terms of the persons and the kinds of intermediated securities collateral to which the rules apply. The FCD does not extend the application of the rules to natural persons[32] and gives Member States the further option of excluding companies if they are not public bodies or regulated financial institutions.[33] The Convention on the other hand does not expressly limit the application of the rules to non-natural persons but does permit contracting states to exclude certain categories of person from the rules governing security interests through a declaration mechanism. It is quite possible that Member States may choose to make declarations that replicate the choices they have made with respect to the domestic application of the FCD.

3.32 The FCD's definition of book entry securities is narrower than that of the Convention. The FCD's defines "book entry securities collateral" as:

> Financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary.[34]

3.33 Unlike the FCD, the Convention covers both financial assets and financial instruments which are capable of being credited to a securities account.[35] Consequently, even if a Member State chooses to limit the application of the Convention rules to those persons covered by the FCD it must note that the Convention rules will nevertheless extend to kinds of financial collateral not already within the scope of the directive.

[30] Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43.

[31] SI 2003 No 3226.

[32] FCD, Article 1(2)(e).

[33] FCD, Article 1(3).

[34] FCD Article 2(g). The definition is replicated in Regulation 3 of the FCAR.

[35] See para 1.54 above.

CONTROL

3.34 The FCD dictates that the creation, validity, perfection and enforceability or admissibility in evidence of a financial collateral arrangement should not require any formal act such as execution of a document, filing or registration.[36] The only perfection requirement which national law may impose in respect of financial collateral should be that the financial collateral is:

> …delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker...[37]

3.35 Neither the FCD nor the FCAR provide a precise definition of what amounts to 'possession and control' of financial collateral. Control could have a number of possible meanings. Control can be 'positive', that is to say, it can confer on the collateral taker the ability to realise the collateral without the consent of the collateral provider. Positive control is necessary to perfect a security interest over uncertificated securities under the UCC.[38] On the other hand, control could be 'negative' in effect by conferring on the collateral taker the right to prevent the collateral provider from disposing of the collateral. It is unclear whether one or both of these positive and negative elements of control are required to satisfy the meaning in the FCD.

3.36 The Law Commission in its recent report on Company Security Interests concluded that 'negative control' was the sole requirement under the Directive. However, this conclusion was reached only by interpreting the relevant article of the Directive in light of its recitals.[39] Without further legislation or a ruling by the European Court of Justice, the definition remains uncertain.

3.37 The Convention adopts a wide interpretation of 'control' in relation to control agreements[40] and designating entries.[41] This interpretation permits a collateral taker to obtain either positive or negative control. It is unclear whether the FCD shares this expansive interpretation of the term. References in the FCD to control requiring 'dispossession'[42] have led us to conclude that only negative control is sufficient. If so, permitting a wider interpretation of control would create an inconsistency in the application of the FCD to book-entry securities collateral as against other types of financial collateral.

[36] FCD, Recital 10 and Article 3.

[37] FCD, Recital 9.

[38] UCC, §9-106 and §8-106(c).

[39] For further discussion of the meaning of control see Law Commission, Company Security Interests (2005) Law Com No 296, pp 137-138.

[40] Defined in Article 1(m).

[41] Defined in Article 1(n).

[42] See FCD, Recital 10 which states: 'This Directive must…provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial arrangements which provide for some form of dispossession...'.

3.38 These inconsistencies aside, we believe that the Convention provides collateral takers with a practical and straightforward means of perfecting a valid security interest over intermediated securities within the EU. Moreover, we would advocate that Member States take this opportunity to further conform the practice of taking security within the EU by declaring that all four of the methods of delivery are effective under their national law. This will avoid the time and cost of determining which delivery methods are valid in other Member States as well as remove the risk of receiving the wrong information about the local law requirements.

Acquisition by an innocent purchaser

The Convention

3.39 An account holder that has securities credited to its account is not subject to an adverse claim so long as the account holder has acquired the securities other than by way of a gift and has no knowledge of the adverse claim at the time of the credit to its account. 'Knowledge' for the purposes of the Convention includes:

> Knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim.[43]

3.40 Knowledge is imputed to an organisation "from the time when it is or ought reasonably to have been brought to the attention of the individual conducting that transaction".[44]

3.41 If a transfer of securities is ineffective or liable for reversal and the securities are subsequently transferred to an innocent purchaser before the original transfer has been reversed, the second transfer will remain effective.[45]

LCG Advice

3.42 The LCG Advice briefly states that:

> An account holder who has a book-entry made in his favour, may rely on that book-entry against the account provider and against any third party unless he knew or ought to have known that the book-entry should not have been made.

Law Commission comments

3.43 While we generally agree with the approach taken by the Convention in protecting innocent purchasers from adverse claims, we have a number of specific observations regarding the current formulation of the defence.

[43] Article 7(4)(b). The test is identical to the test for notice of an adverse claim in UCC§8-105(a)(2).

[44] Article 7(4).

[45] Article 7(5).

A DEFENCE TO CLAIMS RATHER THAN A PROCEDURAL BAR AGAINST CLAIMS

3.44 There are two preliminary points to make about UNIDROIT's decision to create a harmonised defence for account holders. The first is that the Convention rules do not seek to prevent a claimant from bringing a domestic law action against the purchaser; instead they provide the purchaser with the ability to raise a defence against the adverse claim within the context of litigation proceedings. This contrasts with the approach taken by UCC Article 8 which prevents an account holder from enforcing its property rights in order to bring an action against a purchaser other than in exceptional circumstances.[46]

3.45 The second point is that the defence is made available only to purchasers that hold the securities through an intermediary following purchase. Innocent purchasers that directly acquire the legal title to the underlying securities by receiving he bearer certificates or being entered on the issuer's register cannot rely on the Convention defence. They must rely instead on the domestic law applicable to the transfer of directly held securities. Again, this position contrasts with UCC Article 8 which gives all purchasers the same protection against claims made by prior account holders, irrespective of whether the purchaser holds the securities directly or indirectly.

3.46 Casting the protection under the Convention as a defence rather than a bar against actions means that purchasers are not insulated from adverse claims under the Convention to the extent that they are in the US markets. Under the Convention, an account holder whose securities have been misappropriated by its intermediary may choose whether or not to pursue the intermediary or the purchaser or both. In the US, the account holder must look first to its intermediary. Only if its intermediary is insolvent and is unable to remedy the account holder's loss can the account holder succeed in an action against the purchaser in the US and even then it must show that the purchaser has actively colluded in the violation of the intermediary's duty to maintain sufficient securities. This collusion test not only switches the burden of proof to the claimant, but also requires a greater level of fault on the part of the purchaser than the standard of knowledge in the Convention.[47]

[46] UCC §8-503(d) and (e). The account holder may only bring an action if (i) its intermediary is insolvent; (ii) the insolvent intermediary does not have sufficient assets to satisfy the account holder's claim; (iii) the intermediary violated its obligation to maintain sufficient securities; and (iv) the purchaser colluded with the intermediary in violating this obligation.

[47] Note 3 of the Official Comment to UCC §8-503 states that the effect of the choice of the collusion standard is that:

> customers of a failed intermediary must show the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct rather than casting on the transferee the burden of showing that the transferee had no awareness of wrongful conduct by the failed intermediary.

3.47 While the collusion test may swing the balance too far in favour of the purchaser, the requirement that an account holder must look initially to its intermediary does offer a number of advantages in the context of securities settlement. First, it enhances the finality of settlement by reducing the number of transactions that are at risk of reversal.[48] As long as the intermediary can restore the account holder's securities, the transfer made to a purchaser will remain intact irrespective of whether the purchaser was aware of any violation. By contrast, a purchaser under the Convention must generally ensure that it can adequately establish an innocent purchaser defence.

3.48 Secondly, by greatly reducing the circumstances in which an account holder can bring an action against a purchaser, the rule has the effect of ring-fencing the intermediated securities regime.[49] By limiting the operation of domestic law actions against purchasers, the regime is able to provide more consistent and predictable outcomes by basing the remedy on an account holder's rights against its own intermediary. These rights are harmonised in many respects by the Convention whereas the account holder's rights against third parties are not.

3.49 Despite these attractions, the option of following the US approach was not met with great enthusiasm in our preliminary seminars. Nor, realistically, is such a radical step likely to be acceptable to UNIDROIT delegates at this late stage in drafting process. Accordingly, we concede that protecting the innocent purchaser by way of a harmonised defence is the most practical solution, although we should point out that adopting the US approach at a domestic level is an option that would still be compatible with the Convention.

[48] Note 3 of the Official Comment to UCC §8-503 justifies the limitations on claimants to bring claims against transferees as follows:

> The limitations…on the ability of a customer of a failed intermediary to recover securities or other financial assets from the transferee are consistent with the fundamental policies of investor protection that underlie this Article and other bodies of law governing the securities business. The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than on the post hoc perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. Although one can devise hypothetical scenarios where particular customers might find it advantageous to be able to assert rights against someone other than the customer's own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system.

[49] This point is made by C Bamford in 'The Law Commission project on indirectly held securities', The Company Lawyer Vol. 27 No. 9 p 275.

KNOWLEDGE OF ADVERSE CLAIMS

3.50 The standard of knowledge adopted in the Convention does not exactly match the formulation of the test applied by the English courts in relation to commercial transactions. Under English law, the requisite degree of knowledge necessary to defeat a bona fide purchaser defence is met if the defendant has either (i) actual knowledge, (ii) wilfully shuts its eyes to the obvious or (iii) wilfully and recklessly fails to make such inquiries as an honest and reasonable man would have made.[50] Under the Convention, the test for constructive knowledge most closely resembles the wilful shutting of one's eyes to the obvious (category (ii) above). It does not extend to a failure to make such inquiries as an honest and reasonable man would have made (category (iii) above).

3.51 As a result, it will be slightly easier for a purchaser that holds through an intermediary (and is therefore eligible to apply the Convention defence) to establish the innocent purchaser defence than a purchaser of directly held securities or of other commercial assets (who must rely on the bona fide purchaser defence under English law). Unusually, this will also result in the purchaser of an equitable interest (that is to say, the account holder) having a stronger defence than the purchaser of the legal title to securities. This unwelcome disparity is removed in the case of purchasers of the legal title who hold as intermediaries as the terms of the Convention provide that they too are able to rely upon the Convention defence.[51] Purchasers who buy the legal title to securities for their own account are, however, outside of the scope of the Convention and must continue to make such inquiries as an honest and reasonable man would have made.

3.52 While the discrepancy between the English law defence and the Convention defence is unfortunate, on balance we do not object to this approach. The standard of knowledge adopted by the Convention makes it clear to purchasers that they are not required to make any form of inquiries other than in relation to information already known. This best meets the needs of a fast-moving settlement system and reflects market practice. While in theory this leads to a disparity in the level of knowledge required of purchasers of the legal or equitable title in English law, the difference should be negligible in practice. Transactions in securities markets are swift and largely anonymous. A buyer will rarely know the identity of the seller and will not be expected to carry out a thorough investigation of title in order to satisfy its obligations to make inquiries as an honest and reasonable person. We therefore consider the test in the Convention to be satisfactory, particularly in light of the difficulty in finding a formulation that is acceptable to a large number of different legal systems,.

[50] *Polly Peck International plc v Nadir (No 2)* [1992] 4 All ER 769; *Baden v Societe Generale pour Favoriser le Developpement du Commerce et de l'Industrie en France SA* [1992] 4 All ER 769.

[51] Article 7(3)

INTERPLAY BETWEEN THE CONVENTION DEFENCE AND DOMESTIC LAW ACTIONS

3.53 The Convention does not seek to harmonise the legal substance or procedure of actions that can be brought against a purchaser of securities. This is left to domestic law. Instead, the EU ratification of the Convention would provide an EU-wide defence that can be applied in response to actions based on the violation of a claimant's alleged interest in the securities.[52]

3.54 Although not unequivocally stated in the Convention, an acquirer of securities can rely upon other defences (for example, change of position or ministerial receipt) to adverse claims under domestic law. The purchaser should also presumably be allowed to rely upon the domestic law version of the innocent purchaser rule if it grants the purchaser wider protection (for example, if it excludes constructive knowledge from the defence). The Convention defence is intended to provide no more than a minimum level of protection for purchasers.

3.55 Any uncertainty arising from the lack of harmonisation as to the degree of protection will be felt most keenly by claimants. Under the Hague Convention it is the law of the purchaser's account that determines competing priorities between purchaser and original account holder.[53] Accordingly, an account holder bears the risk that its securities will be misappropriated into a securities account governed by a law that gives greater protection to the purchaser than is provided by the Convention. That said, the uncertainty for claimants would be no worse than under the current system.

Settlement Finality

The Convention

3.56 The Convention makes only a limited attempt to harmonise rules that deal with the circumstances in which credits can be reversed. Generally speaking, the domestic laws of each Member State continue to determine the consequences of fraud, misrepresentation, mistake and other causes of invalidity and unenforceability. Article 8(2) of the Convention states that:

[52] Claims for the recovery of securities from an innocent purchaser can be made in the UK under the Proceeds of Crime Act 2002 (POCA) if the assets were obtained through unlawful conduct and sold onto the purchaser. POCA provides good faith purchasers with a defence against recovery of these assets although the defence differs slightly from that of the Convention (see POCA ss. 266, 308). We do not think that claims brought by the Asset Recovery Agency under POCA constitute "adverse claims" as defined in the Convention as they are not claims brought by a person claiming a violation of its interest in the securities. Accordingly POCA's intereaction with the Convention would not need to be considered in these circumstances.

[53] The question of which law should govern in these circumstances is not expressly dealt with in the Hague Convention. The European Commission Staff Working Document, *Legal assessment of certain aspect of the Hague Convention* (3 July 2006) notes at p 10 that it is an unfortunate lapse of drafting that the Hague Convention does not have a normative provision expressly addressing this crucial issue. It does note, however, that the Explanatory Report to the Hague Convention makes it clear that if the law of the purchaser's account awards priority to the purchaser, this law will prevail.

> The domestic non-Convention law and, to the extent permitted by domestic non-Convention law, an account agreement or the rules and agreements governing the operation of a settlement [or clearing] system, may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed.

3.57 The Convention does however ensure that any settlement system rules that prevent the reversal of a credit or the revocation of a transfer order are given precedence over national insolvency rules.[54] Settlement system rules which are directed to the stability of the system or the finality of transactions also take precedence over an, as yet undetermined, number of provisions in the Convention.[55]

LCG Advice

3.58 The LCG Advice states that:

> …rules will be needed within the new legislation as to the circumstances under which a book-entry is liable to be invalidated, and whether the invalidity should be as from the moment the book-entry was made, or only as from a later moment, and whether the invalidity should be achieved by the making of a fresh reverse entry or by treating the initial book-entry as legally void.

Law Commission comments

3.59 Settlement finality is another area that has already been the subject of EU legislation. In 1998, the Settlement Finality Directive[56] (the 'SFD') was passed to reduce systemic and legal risk in payment and securities settlement systems in the EU. The SFD ensures the finality of transfer orders and netting, as well as the enforceability of collateral security within designated systems throughout the EU.

3.60 The SFD is narrow in scope. The 'systems' to which it applies are defined as formal arrangements between (usually) three or more participants with common rules and standardised arrangements for the execution of payment or securities transfer orders between the participants. Member States may designate systems as qualifying. Participants in a system are limited to supervised financial institutions, public authorities, central counter-parties, settlement agents and clearing houses.

3.61 While the SFD does not cover settlement finality outside of designated systems, it does provides invaluable guidance as to how the issues raised by the LCG should be dealt with, if at all, by the Convention. Adopting an approach at variance with the SFD is unlikely to be acceptable within the EU, even if the SFD continued to take precedence over the Convention in relation to designated systems.

[54] Article 22(1).

[55] Article 21. See also para 1.61 above.

[56] Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems.

3.62 Finality in respect of securities transfers is achieved by a combination of three provisions in the SFD. Article 3 of the SFD ensures that transfer orders and netting made before the commencement of insolvency proceedings remain legally enforceable against a participant. Transfer orders are made irrevocable by Article 5 from the moment defined by the rules of the system. Finally, Article 7 abolishes the 'zero hour rule'[57] applied by some Member States to determine the moment at which insolvency proceedings are deemed to take effect.

3.63 The first two of these provisions are closely reflected by Article 22(1) of the Convention. The Convention does not however abolish the 'zero hour rule' which would continue to be effective in jurisdictions that maintain this rule for systems that are not subject to the SFD. Ideally, we would advocate that the Convention include a provision abolishing the 'zero hour rule' altogether.

3.64 Recital 13 of the SFD states that nothing should prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order. An account holder's remedies for fraud, negligence or other wrong-doing in relation to misappropriated securities are therefore unchanged by the SFD and will depend upon the domestic law of the relevant Member State. The Convention again mirrors this light-handed approach by leaving domestic law to determine the circumstances in which credits may be reversed.

3.65 We agree with this approach. It would be unrealistic to attempt to harmonise the laws of each Member State in relation to the variety of different circumstances in which a credit may be liable for reversal.

3.66 Recital 13 of the SFD also deals with the point raised by the LCG as to how invalid credits should be reversed. The Recital indicates that while an account holder may recover securities or damages in the event of an invalid transfer, the manner in which it does so must not lead to an unwinding of a netting transaction or the revocation of the particular transfer order in question.[58] This suggests that if securities are returned to the account holder this could be done by a new transfer order. The original order is not revoked.

3.67 Again, we agree with this approach. To attempt to unpick transfers or to treat them as void could cause significant problems at the higher levels of a clearing and settlement system. It is far better for the finality of transfers and transfer orders that any recovery of securities be effected by a new transfer back to the original account holder.

[57] Under the 'zero hour rule' the commencement of insolvency proceedings was treated as taking effect retroactively from the first minute of the day on which the proceedings were initiated. Under Article 6(1) of the Directive, the moment of opening of insolvency proceedings shall be the moment when the relevant judicial or administrative authority handed down its decision.

[58] Recital 13, Settlement Finality Directive.

3.68 The final issue raised by the LCG relates to the point in time at which credits should be treated as invalid. Should the invalidity take retrospective effect or should it only take effect from the moment that the credit is reversed? In previous drafts of the Convention, this point was expressly left to domestic law. The latest draft is now silent. The Convention would benefit from more clarity on this issue.

Legal recognition of intermediated securities

The Convention

3.69 The Convention imposes on legal systems the requirement that they allow for the effective exercise of rights in publicly-traded securities held through an intermediary.[59] Unless the terms of the particular issue of securities prevent it, the law cannot explicitly prohibit or prevent in practice the exercise of these rights.[60]

Law Commission comments

3.70 While the LCG Advice does not expressly mention the need for legal recognition of intermediated holding, it is fair to say that it is implicit in its Advice. We agree that ensuring the effective exercise of rights in publicly-traded securities is a necessary prerequisite to establishing a harmonised framework for their treatment within the EU. Limiting the rule to publicly traded securities is a satisfactory concession to those Member States wishing to retain certain legal restrictions on the exercise of indirectly held rights in closely-held companies.

Rights of the account holder

The Convention

3.71 The Convention sets out the package of rights that an account holder acquires upon a valid credit. A credit gives the account holder acting for its own account (rather than as an intermediary) the right to enforce the terms of the underlying securities.[61] It also gives an account holder the right to transfer or withdraw the intermediated securities credited to its account.[62] In each case these rights are effective against third parties and enforceable against the account holder's intermediary. In the case of rights to enforce the economic and corporate terms of the securities, these may also be enforceable directly against the issuer of the securities in many civil law systems.[63] The Convention allows the domestic law of the issuer to determine whether an investor has a direct right to enforce these terms against the issuer or only an indirect right enforceable through its intermediary. Under no circumstances is the account holder able to enforce its rights directly against an upper-tier intermediary (the "no-look-through" principle).

[59] Article 13(1).

[60] A law preventing a shareholder from voting its shares in different ways is an example of an effective restriction on the rights of account holders of indirectly held securities as the intermediary voting the shares would be unable to reflect the contrary views of its account holders.

[61] Article 9(1)(a).

[62] Article 9(1)(b).

[63] Article 9(2)(b).

3.72 In addition to the package of rights provided by the Convention, an account holder may have additional rights under the domestic law of the jurisdiction in which its securities account is located.[64] The Convention therefore offers the minimum set of basic rights that account holders will enjoy throughout the EU. In the case of collateral takers, domestic law can impose limits on the collateral taker's ability to enforce these Convention rights.[65]

3.73 An intermediary must take appropriate measures to enable its account holder to exercise these rights. The obligation does not, however, require the intermediary to take any action not within its powers or to establish a securities account with another intermediary.[66] These limitations are intended to protect an intermediary from having to incur unreasonable expense or risk in carrying out its account holders' instructions.

LCG Advice

3.74 The rights that are listed in the LCG Advice as arising upon a book-entry are broadly equivalent to those set out in Article 9 of the Convention. One slight variation is contained in the LCG's reference to the right to instruct the account provider to dispose of, pledge or charge the rights and "to limit the rights in any other way, to change the account on which the securities are held". We are not entirely sure what the last part of this sentence is intended to cover. However we do not necessarily agree that (in the absence of contract terms) an account holder should have an unqualified right to cause the account provider to limit its rights or change the account if this goes beyond disposing of, pledging or withdrawing the securities in accordance with the Convention. An intermediary offering a basic service to its account holders may not be able to accommodate particular instructions from them as to the partial or conditional limiting of its rights in the securities without incurring unreasonable administrative costs.

Insolvency protection

3.75 The Convention protects the rights of account holders and collateral takers from the insolvency administrator and creditors of an insolvent intermediary.[67] It does not however disapply national insolvency laws relating to the avoidance of transactions as a preference or a fraud of creditors nor does it affect rules of insolvency procedure.[68]

LCG Advice

3.76 The LCG Advice states the insolvency of the account holder's immediate account provider shall not affect the book-entry rights. Book-entry rights do not form part of the insolvent account provider's estate.

[64] Article 9(1)(d).

[65] Article 9(3).

[66] Article 10(1).

[67] Article 11.

[68] Article 12.

Law Commission comments

3.77 The protection of an account holder's rights from an insolvent intermediary's creditors is at the core of the intermediary/account holder relationship. The Convention provides this protection to account holders by describing their rights as 'effective' against the insolvency administrator and creditors. We note that this should not prevent an English court from exercising a discretion to award costs out of account holder's assets where the assets of an insolvent company are insufficient to meet the liquidator's costs in administering property held on trust by the company for its clients.[69]

Set-off

The Convention

3.78 The Convention states that the existence of an intermediary between account holder and issuer does not, of itself, prevent the exercise of any right of set-off that would exist if the securities were held directly from the issuer.[70]

LCG Advice

3.79 The LCG Advice makes no comment regarding set-off between account holder and issuer.

Law Commission comments

3.80 Ensuring that an account holder can set-off a debt against an insolvent issuer would be a welcome assurance to investors holding securities indirectly through an intermediary. Set-off can facilitate structures in which a customer holding debt securities can manage the risk of an issuer default. The FMLC Report explains the arrangement as follows:

> The customer arranges for the issuer to have a credit exposure to the customer (for example by entering into a swap with the issuer, and running up an uncollateralised out of the money position). In the event of the issuer defaulting on the bonds, the customer would ensure that it is in effect paid in full by setting its obligation to pay under the swap against its right to be paid under the bonds.[71]

[69] *Re Berkeley Applegate (Investment Consultants) Ltd (No 2)* [1989] Ch 32; *Re Berkeley Applegate (Investment Consultants) Ltd (No 3)*. (1989) 5 BCC 803.. See J Benjamin, "Cross Border Proprietary Rights", Butterworths Journal of International Banking and Financial Law", January (1997),16.

[70] Article 14.

[71] FMLC Report, p 25.

3.81 While the FMLC Report advocates the availability of set-off between issuer and account holder, it makes the right subject to an important qualification. In order for an account holder to assert set-off it must have good title to the securities, free from any defences or rights of set-off of its intermediary and from the claims of third parties.[72] The qualification is necessary to avoid rendering worthless an intermediary's lien, charge or right of set-off against its account holder (for example in relation to the intermediary's fees). If the qualification did not exist, an account holder could circumvent the intermediary's encumbrance by setting-off the whole amount of its encumbered interest in securities against a debt it owes to the issuer without first discharging the obligation it owes to its intermediary.

3.82 For these reasons the Convention's formulation of the right to assert set-off should incorporate a similar qualification.

3.83 Whether intentionally or otherwise, the wording of the Convention implies that a right of set-off is potentially available only when one intermediary exists between the issuer and the ultimate investor. If more than one intermediary separates the issuer from the investor the right of set-off is not available. Logically we can see no reason why the right of set-off should not be made available to an investor that holds through one or more intermediaries. While this may raise difficulties in tracing through complex holding structures, the existence of multiple intermediaries should not of itself prevent set-off if the practical difficulties can be overcome by the investor.

Upper tier attachment

The Convention

3.84 The Convention prevents an attachment order in relation to intermediated securities being granted against the issuer or an upper tier intermediary.[73]

LCG Advice

3.85 The LCG Advice states that book-entry rights may not be enforced, nor is attachment in respect of such rights allowed, against any upper tier intermediary.

Law Commission comments

3.86 The prohibition on upper tier attachment is critical to removing legal uncertainty associated with asserting rights in securities above the level of an account holder's own intermediary. The prohibition also maintains the principle of upper-tier priority in relation to claims between different tiers of account holders. We have no comments on the Article as currently drafted.

[72] FMLC Report, p 18.

[73] Article 15.

Instructions

The Convention

3.87 An intermediary is neither bound nor entitled to give effect to instructions with respect to intermediated securities given by any person other than the account holder. This general rule is subject to (1) the provisions of the account agreement, (2) the rights of collateral takers in respect of the securities, (3) any court order, (4) any mandatory rule of domestic law, and (4) where the intermediary is a system operator, the rules of the system.[74]

LCG Advice

3.88 The LCG Advice makes no comment regarding instructions given to intermediaries.

Law Commission comments

3.89 We agree with the approach taken by the Convention and have no comments on the Article as currently drafted.

Requirement of the intermediary to hold sufficient securities

The Convention

3.90 An intermediary is required to hold sufficient number of securities to satisfy the entitlements of its account holders. If it does not, it must promptly take action to ensure that it satisfies the duty.[75]

LCG Advice

3.91 The LCG sets out a list of minimum duties that an intermediary owes to its account holders. This includes a duty to maintain holdings matching the balance of credits on its account holders' accounts.

Law Commission comments

3.92 An intermediary's duty to hold sufficient securities to satisfy its account holders' entitlements is critical to minimising custody risk. The duty is drafted in general terms in the Convention. It follows the US approach by allowing the intermediary to satisfy the duty without distinguishing between the intermediary's house account and the accounts it holds for customers.[76] If, for example, there is a shortfall in one of the intermediary's customer accounts, the shortfall will not constitute a breach of the Article if the intermediary has sufficient securities of the same description in its own house account to make up the deficiency.

[74] Article 16.

[75] Article 17.

[76] See UCC §8-504.

3.93 As a result, the formulation of the duty to maintain sufficient securities for account holders is integrally linked with the rules on how losses are allocated in the event of a shortfall. If the duty to maintain sufficient securities permits the intermediary to rely on house securities, the loss allocation rules must consequently allow account holders to lay claim to these house securities in the event of a shortfall. The interplay between the two rules is discussed in further detail below.[77]

3.94 Intermediaries will be subject to financial regulation in many Member States requiring them to segregate their house and customer assets. In such circumstances, an intermediary cannot presumably count securities in its house account towards satisfying its duty to maintain sufficient securities without also being in breach of its requirement to segregate its assets from those of its customers.

3.95 It is a corollary of the intermediary's duty to hold sufficient securities that the intermediary must obtain the consent of its account holders if it wishes to grant a security interest over their securities. It is not enough for an intermediary to hold securities of an equivalent number if it has charged some or all of these securities to a collateral taker (by means of a designating entry or some other non-possessory security interest) without the account holders' consent. We believe that Article 17(1) would benefit from greater clarity on this point.

Application of domestic law to obligations, duties and liabilities of an intermediary

The Convention

3.96 Article 18 of the Convention states that:

> The obligations, duties and liabilities of an intermediary under the Convention are subject to the domestic law of the relevant contracting state and, to the extent permitted by that law, the terms of the account agreement.

LCG Advice

3.97 While the LCG Advice does not comment directly on this Article, it does propose that where national laws are incompatible with the aim of the legislation, which is to recognise the legal effects of a book-entry, the national laws will need to be conformed.

3.98 The LCG Advice further states that certain duties of an intermediary should be absolute and therefore immune to alteration by contract. These include the duty to comply with instructions in relation to disposing, pledging and withdrawing securities from an account. The duty to maintain sufficient securities is also considered absolute although the duty to replace missing assets or reimburse the account holder in the case of shortfalls can be contractually limited or excluded. The LCG leaves for further consideration the question of whether other duties should also be immune from contractual variation.

[77] See para X.

Law Commission comments

3.99 The Convention has been drafted with a view to accommodating domestic laws wherever possible by, for example, adopting a functional approach that formulates rules by reference to facts rather than abstract legal principles. The Convention largely operates as a minimum set of rights that an account holder can rely upon as a result of a credit to its account. Rights, duties and liabilities that exist under domestic law continue to exist alongside those created under the Convention.

3.100 In most cases, satisfaction of the duties and obligations imposed by domestic law shall also satisfy these duties and obligations under the Convention. Where, however, domestic laws are incompatible with the Convention, we agree with the LCG's position that it must be the Convention that takes precedence. Making the obligations, duties and liabilities under the Convention subject to domestic law would significantly diminish the legal certainty that the new legislation aims to promote. The legal framework would simply permit the inconsistencies that currently exist between Member States to continue.

3.101 We also agree with the LCG's proposal that certain of the intermediary's obligations should be absolute. An absolute duty to maintain sufficient securities to satisfy account holders' entitlements is appropriate provided that the intermediary's liability for shortfalls can be limited or excluded by contract. We note that, contrary to the LCG position, UCC Article 8 allows for the parties to vary the intermediary's duty to comply with instructions to dispose of securities and to withdraw them from an account. We would tend to agree with this approach. An intermediary should have the contractual flexibility to provide for the manner in which it carries out these duties and to limit the extent of its liability for failure to perform them. It is more appropriate that domestic law govern whether the contractual variation of these duties and liabilities are legally effective.

3.102 Finally, the only duty that UCC Article 8 does express as absolute is the duty of the intermediary to pass on payments or distributions made by the issuer of the securities if the payment or distribution is received by the intermediary.[78] Again, we see merit in this approach and would propose that a similar provision is made in the Convention.

[78] UCC, Article §8-505(b).

Allocation of the securities held by an intermediary

The Convention

3.103 Securities held by an intermediary or credited to its account with an upper tier intermediary are allocated first to its own account holders to the extent necessary to satisfy their entitlements.[79] Contracting states can opt to allow an intermediary to segregate the securities it holds for its own account from those of its account holders so that, in the event of a shortfall in the customer account, the intermediary's own securities are not automatically allocated to its account holders but remain part of its estate.[80]

3.104 In the event of an intermediary's insolvency, any shortfall in the number of securities that it holds is allocated pro rata amongst account holders to whose accounts securities of the same description are credited. Accordingly even segregated customer accounts will share in a loss suffered in a separate customer account if securities of the same description are held in both.[81] If the intermediary is the operator of a settlement system, the shortfall is allocated in accordance with the rules of the system.[82]

3.105 Unless domestic law provides otherwise, the origin or past dealings in securities and the order in which the securities are debited or credited to the respective accounts shall in no way determine the allocation of loss amongst account holders.[83] The Convention rules on allocation of loss are, however, subject to any conflicting rule applicable in the insolvency proceeding of the intermediary.[84]

LCG Advice

3.106 The LCG Advice refers to the allocation of losses only briefly. It states that a rule will be needed within the new legislation as to how insufficient assets held by the account provider are shared among its account holders, if there is an incurable shortfall. The LCG notes that the formulation of this rule is a matter for policy makers.

Law Commission comments

ALLOCATION BETWEEN INTERMEDIARY AND CUSTOMERS

3.107 The Convention's general rule for allocating securities to an intermediary's account holders makes no distinction between securities that are credited to customer accounts and those held by the intermediary for its own account. If a shortfall arises in the customer account, securities held by the intermediary for its own account would be treated as belonging to its account holders in the event of its insolvency.

[79] Article 19(1).

[80] Article 19(4). The opt-out is effected by means of declaration mechanism.

[81] Article 20(1)(a).

[82] Article 20(1)(b).

[83] Article 20(2).

[84] Article 20(3).

3.108 The ability of Member States to opt out of this arrangement and give legal effect to the segregation of intermediary and customer assets is of considerable importance to custodians. English law currently treats securities held by the intermediary outside of customer accounts as belonging to the intermediary. It could have significant implications for an intermediary's credit rating if account holders were given priority over unsecured creditors in relation to these assets. Custodians that held substantial amounts of securities for their own account would be forced to restructure so as to hold customer securities in a separate subsidiary from their own securities holdings.

3.109 If Member States do declare that segregation between customer and house assets is legally effective, it is necessary to consider how this impacts on the intermediary's duty to maintain sufficient securities to satisfy the claims of its account holders. If account holders have no recourse to the intermediary's segregated securities in insolvency, these securities should not count towards its satisfaction of the duty to maintain sufficient securities. As currently drafted Article 17 makes no allowance for this.

ALLOCATION OF LOSSES BETWEEN ACCOUNT HOLDERS

3.110 We turn next to the allocation of losses amongst account holders in the event of their intermediary's insolvency. Loss allocation rules generally follow one of two paths. One approach is to adopt a property law analysis by simply allowing the loss to lie with the account holder whose account was wrongfully or mistakenly debited. The loss of its proprietary entitlement is borne by the account holder unless and until the credit is restored by reversing or invalidating the transfer (as a result of domestic law)[85] or by its intermediary purchasing additional securities. If the intermediary falls insolvent before it can do so, the account holder is left as an unsecured creditor with a personal claim against the intermediary.

3.111 This method of allocating losses confronts practical problems if no debit has been made in the account of a particular account holder. This scenario could occur in a non-matching system where a credit does not have to be matched with a corresponding debit for a transfer to be effective. It can also occur in both matching and non-matching systems where the account holder whose account has been debited without its knowledge holds the securities on behalf of a pool of customers. In both circumstances the system must fall back on a loss allocation method to reconcile the account imbalance (known as a shortfall) between the intermediary's account and the accounts of its customers.

3.112 The second approach to loss allocation is to formulate a loss distribution rule and apply it to all losses affecting innocent account holders irrespective of whether the loss can be attributed to a specific account. In these circumstances, an improper debit to an account is re-credited even if the intermediary has yet to purchase securities to satisfy its duty to maintain sufficient securities. Accordingly, an improper transfer will ultimately result in a shortfall in every case and must be remedied by the loss distribution rules.

[85] This will not be possible if the transferee has a defence, e.g. it is an innocent purchaser.

3.113 How the method of loss distribution is formulated is effectively a question of risk management. The Convention's approach of allocating the loss pro rata amongst account holders in proportion to the size of their entitlements offers an equitable way of sharing the risk. We believe that, in the absence of contract or system settlement rules to the contrary, this method should be universally applied. Consequently, we would argue that the provision in the Convention that allows domestic law to vary the allocation based on past dealings or the order or time at which securities were debited or credited should be removed.[86]

IDENTIFYING THE POOL OF ACCOUNT HOLDERS

3.114 Identifying the pool of account holders that should share in the allocation of loss and fixing the moment at which the entitlements of this pool should be measured are critical to ensuring that the loss allocation method is consistently employed in different Member States.

3.115 The Convention establishes the pool as any account holder of the intermediary who holds securities of the same description as those that have been lost. Under this formulation, the segregation[87] of individual accounts has no effect in protecting account holders from losses in other accounts. The Convention is silent as to the time at which this pool should be measured. As the composition of an intermediary's pool of account holders can fluctuate significantly from day to day, the lack of a common approach on this point could lead to material differences in outcomes between Member States.

3.116 We propose that the pool of account holders should be measured at the moment of the intermediary's insolvency. It is not the shortfall itself but the intermediary's inability to remedy the shortfall that account holders must consider when choosing to hold securities through one or more intermediaries. As this credit risk may change over time it is the account holders that are assuming the credit risk at the moment of the intermediary's insolvency that should bear the loss.

3.117 We have serious reservations about the Convention's decision to allocate losses to all account holders irrespective of whether they have segregated their accounts. Under English law, each segregated account represents a separate trust of assets held for the particular beneficiaries of that trust. Allocating losses across segregated accounts represents a fundamental break from this traditional trust analysis.

[86] Article 20(2).

[87] By segregation, we mean the opening of a separate account by the intermediary with the issuer or intermediary above it in relation to the securities that it holds for a particular account holder.

3.118 Our concerns also extend to the practical effect of choosing not to recognise the effect of segregation between customer accounts. Although pro rata sharing of risk is an attractive means of managing risk, account holders who actively choose (and pay for) the segregation of their account should be able to opt out of this method. Some may have good reason to do so. For example, if an investor has no intention of carrying out frequent trades in its account, it may not want to participate in a pooled account where a large volume of trades is likely to increase the risk of operational errors.[88] We speculate that removing the ability to shield accounts from losses in other accounts held by an intermediary could compel custodians to restructure their operations into separate subsidiaries with each subsidiary operating a single account or possibly multiple accounts that share a similar risk profile.

3.119 We therefore suggest that an opt-out clause should be available to contracting states similar to the opt-out for segregation arrangements between the intermediary's house account and customer accounts.[89]

CIRCUMSTANCES IN WHICH LOSS ALLOCATION METHOD IS APPLIED

3.120 The loss sharing rules set out in the Convention apply to "any insolvency proceeding in respect of an intermediary".[90] In our opinion, limiting the application of the rule to insolvency situations is too narrow if the correct interpretation of the provision is to restrict the application of the loss sharing rules to situations where the account holders' own intermediary is insolvent. In longer chains of ownership, losses may need to be allocated amongst accounts held by solvent intermediaries where the insolvency of an upper-tier intermediary results in shortfalls being created in the accounts of solvent intermediaries below it. In the absence of settlement system rules dealing with the allocation of losses, the Convention's loss allocation rules should apply as a default regime for both solvent and insolvent intermediaries.

Provisions in relation to collateral transactions

The Convention

3.121 The Convention sets out rules for the enforcement of a security interest over intermediated securities. The Convention also protects the effectiveness of contractual provisions that allow for the top-up or substitution of collateral in the period prior to a collateral-giver's insolvency.

3.122 Contracting states are entitled to declare that these rules do not apply under its domestic law or may choose to declare that these rules in relation to (1) collateral agreements entered into by natural persons, or (2) intermediated securities that are not listed, or (3) certain types of secured obligations.

[88] An account holder may also wish to ring fence itself from accounts that operate by way of contractual settlement (i.e. the intermediary credits account holders before the securities have been actually delivered into the account).

[89] See para X above.

[90] Article 20(1).

LCG Advice

3.123 The LCG Advice contains no reference to the enforcement and use of collateral.

Law Commission comments

3.124 As in the case of the creation of security interests, the rules set out in the Convention should be compatible with the FCD. To a large extent the provisions of the Convention replicate exactly the relevant provision in the FCD.

3.125 A comparison of the Convention rules and the FCD does throw up the following discrepancies:

(1) Member States that do not allow appropriation on 27 June 2002 are not obliged to recognise it under the FCD.

(2) Where securities are transferred to the collateral taker's account there is a presumption that they can be re-used under the Convention, whereas under the FCD the right of re-use must be specified in the collateral arrangement.[91]

[91] FCD, Article 5(1).

APPENDIX A

PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING

(Revised to show Law Commission's suggested underlined amendments)

INTERMEDIATED SECURITIES

CHAPTER I - DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION

Article 1

[Definitions]

In this Convention:

(a) *"securities"* means any shares, bonds or other financial instruments or financial assets (other than cash) or any interest therein, which are capable of being credited to a securities account;

(b) *"securities account"* means an account maintained by an intermediary to which securities may be credited or debited;

(c)*"intermediary"* means a person that 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;

(d) "maintain" means, in the context of a securities account, to undertake to treat the person in whose name the securities are credited as entitled to exercise the rights set out in Article 9 in respect of them [and such undertaking shall be presumed in the absence of evidence to the contrary.]

(e) *"account holder"* means 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);

(f) *"account agreement"* means, in relation to a securities account, the agreement with the relevant intermediary governing that securities account;

(g) *"intermediated securities"* means the rights of an account holder resulting from a credit of securities to a securities account[1];

[1] This definition remains under consideration. Questions have been raised, for example, as to the appropriateness of the particular term "intermediated securities", as to whether it should be replaced by "intermediated rights", and as to whether the definition should be expanded so as to include terms that currently form part of Article 4.

(h) *"relevant intermediary"* means, with respect to a securities account, the intermediary that maintains the securities account for the account holder;

(i) *"disposition"* means an act of an account holder disposing of intermediated securities and includes a transfer of title, whether outright or by way of security, and a grant of a security interest;

(j) *"adverse claim"* means, with respect to any securities, a claim that a person has an interest in those securities that is effective against third parties and that it is a violation of the rights of that person for another person to hold or dispose of those securities;

(k) *"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;

(l) *"insolvency administrator"* means a person (including a debtor in possession where applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;

(m) securities are *"of the same description"* as other securities if they are issued by the same issuer and:

(i) they are of the same class of shares or stock; or

(ii) in the case of securities other than shares or stock, they are of the same currency and denomination and form part of the same issue;

(n) *"control agreement"* means an agreement between an account holder, the relevant intermediary and a collateral taker, or, if so permitted by the domestic non-Convention law, an agreement between an account holder and a collateral taker of which notice is given to the relevant intermediary, which relates to intermediated securities and provides that, in such circumstances and as to such matters as may be specified in the agreement or provided by the domestic non-Convention law, the relevant intermediary is not permitted to comply with any instruction given by the account holder without having received the consent of the collateral taker[, or is obliged to comply with any instructions given by the collateral taker without any further consent of the account holder][2];

(o) *"designating entry"* means an entry in a securities account made in favour of a collateral taker in respect of the securities account or in respect of specified securities credited to the securities account, which, under the account agreement, a control agreement or the domestic non-Convention law, has the effect that, in specified circumstances and as to specified matters, the relevant intermediary is not permitted to comply with any instructions given by the account holder without having received the consent of the collateral taker[, or is obliged to comply with any instructions given by the collateral taker without any further consent of the account holder][3];

[2] If the FCD definition of "control" is identified as requiring 'negative' control, the reference to positive control should be deleted.

[3] See footnote above.

(p) *"domestic non-Convention law"* means the domestic provisions of law of the State whose law is applicable under Article 2, other than those provided in this Convention;

(q) "non-consensual security interest" [to be defined];

(r) "segregation arrangement" means an arrangement whereby the relevant intermediary holds an account with the issuer or another intermediary to which are credited only securities in relation to a particular account holder or account holders of the relevant intermediary.

(s) "securities settlement [or clearing] system" means [a system] [an entity] which:

(i) clears, settles or clears and settles securities transactions;

(ii) [has rules and agreements with its participants that are publicly accessible];

(iii) is operated by a central bank or conducts operations that are supervised [by a regulator that has oversight over its rules and agreements];

(iv) has been notified as a securities settlement [or clearing] system in a declaration by a Contracting State, [or falls within a category of [systems] [entities] that have been notified as securities settlement [or clearing] systems in a declaration by a Contracting State and has been specifically identified as falling within that category in a publicly accessible website of its regulator which also specifies the date on which it first was designated as falling within that category];

provided that a declaration referred to in this sub-paragraph must be made on the grounds of the reduction of risk to the stability of the financial system;

(t) "collateral taker" means a person to whom a security interest in intermediated securities is granted;

(u) "collateral provider" means an account holder by whom a security interest in intermediated securities is granted;

(v) "collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of a security interest in intermediated securities.

Article 2

[Scope of application]

This Convention applies where rules of private international law of the forum state designate the law of a Contracting State.

Article 3

[Principles of interpretation]

1. - In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to its international character and to the need to promote uniformity and predictability in its application.

2. - Questions concerning matters governed by this Convention which are not expressly settled in the Convention are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the domestic non-Convention law.

CHAPTER II – TRANSFER OF INTERMEDIATED SECURITIES

Article 4

[Acquisition and disposition of intermediated securities]

1. - Intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step is necessary, or may be required by the domestic non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - Intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - Without prejudice to any rule of the domestic non-Convention law requiring that no credit or debit be made without a corresponding debit or credit, a debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit has been made.

5. - Debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.

6. - This Article does not preclude any other method provided by the domestic non-Convention law for the acquisition or disposition of intermediated securities.

Article 5

[Security interests in intermediated securities]

1. - An account holder may grant to a collateral taker a security interest in intermediated securities so as to be effective against third parties by:

(a) entering into a collateral agreement with the collateral taker; and

(b) delivering the intermediated securities to the collateral taker;

and no further step is necessary, or may be required by the domestic non-Convention law.

2. - Intermediated securities shall be treated as delivered to a collateral taker if they are credited to a securities account of the collateral taker.

3. – Intermediated securities shall also be treated as delivered to a collateral taker –

(a) if the relevant intermediary is itself the collateral taker and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph;

(b) if a designating entry has been made and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph; or

(c) if a control agreement applies and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph.

4. - A Contracting State may declare that under its domestic non-Convention law the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 3 is sufficient, to constitute delivery of intermediated securities to a collateral taker.

5. - A Contracting State may declare that under its domestic non-Convention law this Article shall not apply in relation to security interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration.

6. - If the domestic non-Convention law so permits, a security interest may be granted –

(a) in respect of a securities account (and such a security interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account); or,

(b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

7. - The domestic non-Convention law determines:

(a) in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties; and

(b) the evidential requirements in respect of a collateral agreement and the delivery of intermediated securities to a collateral taker.

8. - This Article does not preclude any other method provided by the domestic non- Convention law for the grant of a security interest in intermediated securities, but the priority of a security interest granted by any such other method is subject to the rules in Article 6.

Article 6

[Priority among competing security interests]

1. - This Article determines priority between security interests in the same intermediated securities.

2. - Security interests that become effective against third parties under Article 5(3):

(a) have priority over any security interest that becomes effective against third parties by any method permitted by the domestic non-Convention law other than those provided by Article 5(2) or (3); and

(b) rank among themselves according to the time of occurrence of the following events:

(i) when the collateral agreement is entered into, if the relevant intermediary is itself the collateral taker;

(ii) when a designating entry is made;

(iii) when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary.

3. - Where an intermediary enters into a control agreement with a collateral taker or makes a designating entry in favour of a collateral taker, the security interest of the collateral taker has priority over any security interest of the intermediary that is effective against third parties under Article 5(3).

4. - A non-consensual security interest in intermediated securities arising or recognised under any rule of the domestic non-Convention law has such priority as is afforded to it by that law.

5. - Subject to paragraph 2, the priority of any competing security interests in the same intermediated securities is determined by the domestic non-Convention law.

6. - As between persons entitled to any security interests referred to in paragraph 2, paragraph 3 and, to the extent permitted by the domestic non-Convention law, paragraph 4, the priorities provided by the preceding paragraphs may be varied by agreement between those persons, but any such agreement does not affect third parties.

Article 7

[Acquisition by an innocent person of intermediated securities]

1. - Where securities are credited to a securities account under Article 4 and the account holder does not at the time of the credit have knowledge of an adverse claim with respect to the securities –

(a)the account holder is not subject to the adverse claim;

(b) the account holder is not liable to the holder of the adverse claim; and

(c) the credit is not ineffective or reversible on the ground that the adverse claim[4] affects any previous debit or credit made to another securities account.

2. - Paragraph 1 does not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

[4] Further consideration to be given to whether to deal specifically with adverse claims of the intermediary (e.g. by amending the definition of adverse claim).

3. - An intermediary who makes a debit, credit, or designating entry to a securities account is not liable to the holder of an adverse claim with respect to intermediated securities unless at the time of such debit, credit or designating entry the intermediary has knowledge of the adverse claim.

4. - For the purposes of this Article a person acts with knowledge of an adverse claim if that person:

(a) has actual knowledge of the adverse claim; or

(b) has knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim;

and knowledge received by an organisation is effective for a particular transaction from the time when it is or ought reasonably to have been brought to the attention of the individual conducting that transaction.

[6. - Notwithstanding Article 8[(2)], if:

(a) securities have been credited to a securities account of an account holder, or have been designated in favour of another person in the manner described in Article 5, in circumstances such that the credit or designating entry is not effective or is liable to be reversed; and

(b) before that credit or designating entry has been [cancelled or] reversed, the securities are credited to a securities account of a third party, or are designated in the manner described in Article 5 in favour of a third party (such a third party being in either case referred to in this sub-paragraph as *"the acquirer"*), under a further disposition,

the fact that the initial credit or designating entry was made in circumstances such that it is not effective or is liable to be reversed does not make the further credit or designating entry ineffective, in favour of the acquirer, against the person making the further disposition, the relevant intermediary or third parties unless:

(i) the further credit or designating entry is made conditionally and the condition has not been satisfied;

(ii) the acquirer has knowledge, at the time when the further credit or designating entry is made, that it is made as a result of the further disposition and that the further disposition is made in the circumstances referred to in this paragraph; or

(iii) the further disposition is made by way of gift or otherwise gratuitously.] [5]

[5] Further consideration to be given to whether there should be a more general protection against reversal based on reversal etc. of earlier transactions; paragraphs 4 and 5 reproduce Article 7(6) and (7) of Doc. 24.

[6. - For the purposes of paragraph 5 the acquirer has knowledge that the further credit or designating entry is made as a result of a purported disposition made in the circumstances referred to in that paragraph if the acquirer has actual knowledge that it is so made, or has knowledge of facts sufficient to indicate that there is a significant probability that it is so made and deliberately avoids information that would establish that that is the case.]

Article 8

[Lack of authorisation, ineffectiveness and reversal]

1. - A debit of securities to a securities account or a designating entry is not effective unless the relevant intermediary is authorised to make that debit or designating entry:

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to a security interest arising under Article 5(3), by the collateral taker; or

(b) by the domestic non-Convention law.

2. - The domestic non-Convention law and, to the extent permitted by the domestic no-Convention law, an account agreement or the rules and agreements governing the operation of a settlement [or clearing] system, may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed.

3. – Subject to Article 7, the domestic non-Convention law determines –

(a) where a debit or designating entry is not authorised or a debit, credit or designating entry is otherwise ineffective, the consequences of such ineffectiveness;

(c) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal.

CHAPTER III – RIGHTS OF THE ACCOUNT HOLDER

Article 9

[Intermediated securities]

1. - The credit of securities to a securities account confers on the account holder:

(a) the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights

(i) where the account holder is not an intermediary or is an intermediary acting for its own account; and,

(ii) in any other case, if the domestic non-Convention law so provides;

(b) the right, by instructions to the relevant intermediary, to dispose of the securities in accordance with Articles 4 and 5;

(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 under the law under which the securities are constituted, the terms of the securities and the account agreement;

(d) subject to this Convention, such other rights as may be conferred by the domestic non-Convention law.

2. - Unless otherwise provided in this Convention,

(a) the rights referred to in paragraph 1 are effective against third parties;

(b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the law under which the securities are constituted;

(c) the rights referred to in paragraph 1(b) and 1(c) may be exercised only against the relevant intermediary.

3. - Where securities are credited to a securities account of an account holder in the capacity of collateral taker under Article 5, the domestic non-Convention law determines any limits on the rights described in paragraph 1.

Article 10

[Measures to enable account holders to receive and exercise rights]

1. - An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 9(1), but this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary.

2. - This Article does not affect any right of the account holder against the issuer of the securities.

Article 11

[Rights of account holders in case of insolvency of intermediary]

The rights of an account holder under Article 9(1), and a security interest that has become effective against third parties under Article 5(2) or (3), are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 12

[Effects of insolvency]

Subject to Article 22 and Article 26, nothing in this Convention affects:

(a) any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or

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

Article 13

[Position of issuers of securities]

1. - The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise of the rights attached to such securities which are so held. This is without prejudice to the terms of issue of the securities.

2. - In particular, the law of a Contracting State shall recognise the holding of securities described in paragraph 1 by a person acting in his own name on behalf of another person (including a nominee) and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description.

Article 14

[Set-off]

1. As between an account holder who holds intermediated securities for its own account and the issuer of those securities, the fact that the account holder holds the securities through one or more intermediaries shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities otherwise than through one or more intermediaries.

2. For the purposes of paragraph 1, any security interest of an intermediary that becomes effective against third parties under Article 5(3) [or under domestic non-Convention law] in respect of the intermediated securities shall be taken into account in determining whether or not the account holder has rights of set-off against the issuer.

3. - This Article does not affect any express provision of the terms of issue of the securities.

CHAPTER IV – INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM

Article 15

[Prohibition of upper-tier attachment]

1. - No attachment of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any intermediary other than the relevant intermediary.

2. - In this Article *"attachment"* means any judicial, administrative or other act or process for enforcing or satisfying a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of the account holder or for freezing, restricting or impounding property of the account holder in order to ensure its availability to enforce or satisfy any future such judgment, award or decision.

Article 16

[Instructions to the intermediary]

1. - Subject to paragraph 2 [and Article 8(1)], an intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. - Paragraph 1 is subject to:

(a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;

(b) the rights of any person (including the intermediary) who holds a security interest created under Article 5;

(c) subject to Article 15, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) any mandatory rule of the domestic non-Convention law; and

(e) where the intermediary is [the operator of] a securities settlement [or clearing]system, the rules of that system.

Article 17

[Requirement to hold sufficient securities]

1. - An intermediary must, for each description of securities, hold securities and intermediated securities of an aggregate number and amount at least equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains [for account holders][6].

[6] The square brackets in paragraph 1 reflect the need to ensure that the Convention does not relax more stringent requirements under a domestic non-Convention law that might, for example, require the intermediary to maintain with another intermediary securities sufficient to reflect securities that the intermediary carries on its books for its own account. Consideration may be given to addressing this issue more generally in the convention.

2. For the purposes of paragraph 1, any securities and intermediated securities that are incapable of being allocated to account holders as a result of a declaration made under Article 19(4) shall not be included in the aggregate number and amount held by the intermediary.

3. - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must [immediately] [promptly] take such action as is required to ensure that it holds sufficient securities and intermediated securities of that description.

4. - The preceding paragraphs do not affect any provision of the domestic non-Convention law, or, subject to the domestic non-Convention law, any provision of the rules of a securities settlement [or clearing] system or of an account agreement, relating to the allocation of the cost of ensuring compliance with the requirements of those paragraphs.

Article 18

[Application of domestic non-Convention law and account agreement to obligations of intermediary]

1. – Without prejudice to paragraph 2, the obligations and duties of an intermediary under this Convention shall prevail over any applicable provision of the domestic non-Convention law to the extentthat they conflict.

2. Subject to the exceptions in paragraph 3, the obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary are, to the extent permitted by domestic non-Convention law, subject to the account agreement.

3. Paragraph 2 is subject to:

(a) the intermediary's duty to pass on to its account holder any payments and distributions made by the issuer that it receives;

(b) the intermediary's liability for its breach of the duty referred to in sub-paragraph (a) above; and

(c) the intermediary's duty to hold sufficient securities in accordance with Article 17 (but not, for the avoidance of doubt, the intermediary's liability for a breach of Article 17).

Article 19

[Allocation of securities to account holders' rights: securities so allocated not property of the intermediary]

1. - Securities of each description held by an intermediary or credited to securities accounts held by an intermediary with another intermediary shall be allocated to the rights of the account holders of that intermediary to the extent necessary to ensure that the aggregate number or amount of the securities of that description so allocated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary for its account holders.

2. - Securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of its unsecured creditors in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of unsecured creditors of the intermediary.

3. - Subject to paragraph 4, the allocation required by paragraph 1 shall be effected by the domestic non-Convention law and, subject to the domestic non-Convention law, by arrangements made by the relevant intermediary.

4. - A Contracting State may declare that under its domestic non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary with another intermediary or with the issuer under a segregation arrangement for the segregation of securities held by the relevant intermediary for the benefit of its account holders and does not apply to securities held with another intermediary or with the issuer for the relevant intermediary's own account.

Article 20

[Loss sharing in case of insolvency of the intermediary]

1. - I the aggregate number or amount of securities and intermediated securities of any description held by an intermediary is less than the aggregate number or amount of securities of that description credited to securities accounts and the intermediary is subject to insolvency proceedings or is not obliged to remedy the shortfall, the shortfall shall be allocated:

(a) subject to sub-paragraph (b), among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited to their securities account at the commencement of insolvency proceedings; or

(b) where the intermediary is [the operator of] a securities settlement [or clearing] system and the rules or agreements governing the operation of the system make provision for the allocation of the shortfall, in the manner so provided.

2. - In any allocation required under paragraph 1(a) no account shall be taken of:

(a) the origin of, or any past dealings in, any securities held by the intermediary or credited to securities accounts held by the intermediary with another intermediary; or

(b) the order in which or time at which any securities are credited or debited to the respective securities accounts of account holders.

4. – A Contracting State may declare that under its domestic non-Convention law the allocation required by sub-paragraph 1(a) shall apply only to account holders in relation to whose account the shortfall has arisen and not to account holders whose securities are credited to a separate account with the intermediary under a segregation arrangement.

5. The preceding paragraphs are subject to any conflicting rule applicable in the insolvency proceeding of the intermediary.

Article 21

[Overriding effect of certain rules of securities settlement [or clearing] systems]

Any provision of the rules or agreements governing the operation of a securities settlement [or clearing] system [which is directed to the stability of the system or the finality of transactions effected through the system] shall, to the extent of any inconsistency, prevail over any provision of [Articles 8,X,Y, …] [this Convention].

Article 22

[Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement [or clearing] system]

1. - Any provision of the rules or agreements governing the operation of a securities settlement [or clearing] system [which is directed to the stability of the system or the finality of transactions] shall have effect notwithstanding the commencement of an insolvency proceeding in respect of [the operator of] the system or any participant in the system in so far as that provision:

    (a) precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry in, a securities account which forms part of the system after the time at which that debit, credit or designating entry is treated as final under the rules of the system;

    (b) precludes the revocation of any instruction given by a participant in the system for making a disposition of securities, or for making a payment relating to an acquisition or disposition of securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system.

2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur by mandatory operation of the insolvency law of a Contracting State.

CHAPTER V – SPECIAL PROVISIONS WITH RESPECT TO COLLATERAL TRANSACTIONS[7]

Article 23

[Scope and interpretation in Chapter V]

1. - This Chapter applies to collateral agreements under which a collateral provider delivers intermediated securities to a collateral taker under Article 5(2) or Article 5(3) in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

[7] Further consideration will be given to the terminology of this Chapter and its consistency with that of the remainder of the preliminary draft Convention.

2. - In this Chapter –

(a) *“enforcement event”* means, in relation to a collateral agreement, an event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security;

(b) “*collateral securities”* means intermediated securities delivered under a collateral agreement;

(b) “*secured obligations”* means the obligations secured by a collateral agreement.

Article 24

[Enforcement]

1. - On the occurrence of an enforcement event, the collateral taker may realise the collateral securities:

(a) by selling them and applying the net proceeds of sale in or towards the discharge of the secured obligations;

(b) by appropriating the collateral securities as the collateral taker’s own property and setting off their value against, or applying their value in or towards the discharge of, the secured obligations, provided that the collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose.

2. - Collateral securities may be realised under paragraph 1:

(a) subject to any contrary provision of the collateral agreement, without any requirement that:

(i) prior notice of the intention to realise shall have been given;

(ii) the terms of the realisation be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner; and

(c) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

3. - A collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully discharged, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(a) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

(b) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

4. - This Article is without prejudice to any requirement of the domestic non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

Article 25

[Right to use collateral securities]

1. - If and to the extent that the terms of a collateral agreement so provide (or, where collateral securities are delivered to the collateral taker under Article 5(2), if and to the extent that the terms of the collateral agreement do not provide otherwise), the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a *"right of use"*).

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the *"original collateral securities"*) by transferring to the collateral provider, not later than the discharge of the secured obligations, securities of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where the collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the secured obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant collateral agreement.

Article 26

[Top-up or substitution of collateral]

Where a collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities in order to take account of changes in the value of the collateral provided under the collateral agreement or in the amount of the secured obligations [, in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker] or, to the extent permitted by the applicable law as determined by the private international law rules of the forum, in any other circumstances specified in the collateral agreement; or

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value, the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the secured obligations have been incurred.

Article 27

[Declarations in respect of Chapter V]

1. - A Contracting State may declare that this Chapter shall not apply under its domestic non-Convention law.

2. - A Contracting State may declare that under its domestic non-Convention law this Chapter shall not apply –

(a) in relation to collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which provide for secured obligations falling within such categories as may be specified in the declaration.