The Geneva Securities Convention : objectives, history and guiding principles

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PART I

The Geneva Securities Convention and the future EU legislation in comparison

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The Geneva Securities Convention: objectives, history, and guiding principles

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1.1 Money, securities and the intermediary holding system

Capital markets form the essentially virtual and increasingly global marketplace where money flows from investors to governments, companies and some international financial institutions that use these funds for their operation and growth. However, investors do not part with their money for free. They are offered future cash flows, such as interest and repayment of capital (for bonds) or dividends (for shares). The issuers of these bonds, shares, and any variation thereof sell promises of future cash flows to investors. Indeed, they issue rights to investors in exchange for their cash. Such rights are enforceable against the relevant issuer. They typically consist of monetary claims, fixed or contingent; voting and other rights to participate in certain decisions in respect of the issuer; or any combination thereof.

Investors are willing to pay good money against rights entitling them to future cash flows and some degree of decision-making power. But that is not enough. Such rights would have less value if investors did not have the ability to re-sell their rights to other investors. Absent this feature, they would be stuck with their bonds until redemption (note, however, that some bonds are perpetual), and with their shares until the issuer goes bankrupt or is otherwise liquidated, which is not usually what investors hope for.

In the capital markets, the rights issued to investors must therefore be negotiable, i.e., capable of being transferred by way of sale, or being used as collateral in a credit or other financial transaction. The problem with such rights is that they are intangible. Transferring intangible rights is fraught with risks. How can the seller or collateral provider prove that she is the legal owner of such rights? How can she prove their actual contents and extent? How will the buyer or the collateral provider be able to exercise them and, if need be, to sell or pledge them further on? Entitlement to and transfer of intangible rights raise significant evidential and legal problems. That creates a variety of risks, ranging from legal uncertainty to operational mistakes and fraud.

By contrast, physical property is much easier to trade, because the thing that is being sold or pledged has physical substance and can be delivered to the buyer or to the secured party. There are also risks in transaction over tangible property, such as legal title, authenticity and other qualities of that thing. Legal rules have evolved so as to protect against such risks to various degrees, from the protection of an innocent acquirer (*acquéreur de bonne foi*) to remedies against the seller for defective goods.

The law can never fully protect the acquirer of either tangible or intangible property, but there is no doubt that tangible, movable property is usually easier to transfer, and allows the acquirer to more easily assess its risks and protect against their occurrence.

It was therefore a great innovation of mercantile law and of the infant capital markets to start treating intangible rights against issuers *as if* they were tangible movable property. Issuing physical securities representing fungible fractions of the rights created by an issuer to a large degree allowed such rights to be treated *as if* they were movable property. The securities were not only evidence of the rights issued ('certificates'), they were also the movable vehicles whose transfer according to the law governing chattels also operated the transfer of the intangible rights 'attached to' or 'incorporated in' them. Investment securities, *valeurs mobilières*, *Wertpapiere* were a major innovation of the financial markets. In their purest form as bearer certificates, securities might actually be subject to the very rules applying to chattels and incur the same types of risk (e.g., lack of authenticity, defective title). Registered securities have retained mixed features because registration of the transfer was and still is required to effect transfer of title or to procure or allow the exercise of all or some of the rights.

Why use the past tense for most of the last paragraph? Because transferring securities as pieces of movable property has become quite exceptional. It is even impossible or prohibited in certain jurisdictions which have legally abolished the issuance of certificated securities, at least in so far as listed securities are concerned. Over the last sixty years, the great innovation of turning intangible rights into tangible, movable property has been rendered impractical, costly, and undesirable. At the risk of oversimplifying the story, issuers find it costly to issue and redeem certificates and coupons, to handle registration of investors, and to deal with lost or stolen certificates. For investors, keeping certificated securities may be quite inconvenient. For example, storing them in a safe deposit box is somewhat risky and/or costly; handling the certificates every time one wants to sell, pledge or redeem the certificates securities or simple to cash in the coupons is inconvenient. Banks, securities dealers and other financial intermediaries are willing to earn a fee for keeping those certificates in safe custody, but they would rather avoid detaching coupons and dealing with the physical delivery of certificates for every transaction. Notwithstanding economies of scale, processing costs and operational risks increase exponentially with the number of issues and with transaction speeds. Governments have taxation and anti-money laundering issues of their own, with certificated securities moving from hand to hand.

In the same way as private cars and highways allowed mass tourism and the development of sprawling suburbs, certificated securities were the vehicles that allowed the expansion of the capital markets. However, ever-more cars, moving at ever-increasing speed, created increasing traffic jams. Investors, issuers, and the intermediaries for the capital markets set about creating huge and safe parking lots where securities would be immobilised most of the time, if not for ever. Thus appeared central securities depositories (CSDs), to which banks and other financial institutions would deliver their own securities and the securities of their clients for safekeeping. At an ever-increasing scale starting from the 1960s, the physical delivery of securities was replaced by credits and debits in securities accounts maintained by CSDs for their participating financial institutions, and by financial institutions for their clients or for other financial institutions. By doing so, participants in the capital markets actually ceased to treat securities as movable property and resumed dealing with the rights attached to the securities, though not by way of assignment in the legal sense, but in a sort of a book-keeping way.

In other words, while one of the great innovations of capital markets was to load intangible rights into physical vehicles, to facilitate their circulation in the markets and among investors, the costs and risks of exponentially crowded highways connecting markets and investors resulted in the parking of the vehicles. The vehicles themselves became largely irrelevant, and sales and other transactions in respect of the rights stored in the vehicles were henceforth recorded in special accounts called 'securities accounts'.

It is interesting to note that whether vehicles of the same brand and type, or securities of the same issue, are considered as fungible bulk and their transfer recorded by a debit and a credit of a given number, or whether they are individually registered and a record is kept of every particular vehicle or security transferred in any given transaction, is a matter of national preference.[1] The huge data-handling capacities of modern information technologies accommodate either approach.

If the market can work by keeping a record of vehicles immobilised all year long, why continue manufacturing individual cars in large numbers? Might issuers instead consider creating a small truck containing all the rights comprised in a single issue? Or might they abstain from making cars completely, and use the same securities accounts for rights which could be registered somewhere, rather than manufactured in the form of cars? Both approaches would save time and cost and might help minimise risks, assuming of course that investors would accept forgoing the right to take their car out for a drive.

This is actually what happened. Once the immobilisation of securities with CSDs became generally accepted, issuers tested the market acceptance of jumbo certificates – each representing a whole issue, and fully dematerialised securities – and discovered that this was often acceptable. In most countries where full dematerialisation of listed securities has not yet been statutorily imposed, dematerialised securities and jumbo certificates are driving out certificated securities. National differences remain in this area, which are deeply linked to market usage, operational arrangements, investment costs, legal doctrines and investor preferences.

1.2 New risks, new legal issues

When bonds and shares were traded as certificated securities, risks did exist, which the laws allocated among participants to a transaction: defective title and protection of bona fide purchasers, forged certificates, effectiveness of defences and of restrictions not documented in the certificate, implied representations and warranties by the transferor, etc. But once

1 A very good example of the latter is Spain, and described by Francisco Garcimartín in Chapter 12 of this book. Whether securities are fungible or not remains controversial in English law: see Goode, 'Are Intangible Assets Fungible?', [2003] *Lloyd's Maritime and Commercial Law Quarterly*, 379, and is a core issue in the English 'Rascals' case which arose from the insolvency of Lehman Brothers; see *Pearsons & Ors as the Joint Administrators of Lehman Brothers International (Europe) (In Administration)* v. *Lehman Brothers Finance SA* [2011] EWCA Civ. 1544, and its discussion by Dilnot and Harris, 'Ownership of a Fund', 272.

such securities circulated without physical delivery, most of these rules became de facto obsolete. The acquirer could no longer rely on possession of the certificate as prima facie evidence of the transferor's title, nor could he read the fine print on the certificate.

New risks emerge when the delivery of securities is replaced by book-entries in securities accounts. The financial intermediary keeping the books may make mistakes. It may act upon instructions that were forged or not otherwise authorised by the account holder. More rights may happen to be credited to the securities accounts of clients than the intermediary itself has in custody or which are credited to its own account with the CSD or other intermediaries. In the intermediated world, mistakes and fraud do not generally affect certificates; they relate to instructions received and entries made by the intermediary.

Indeed, the immobilisation and dematerialisation of securities create huge efficiencies, at the cost of relying almost exclusively on the operational safety and financial soundness of CSDs, banks and other financial intermediaries maintaining securities accounts for their clients. In most jurisdictions, all these intermediaries are regulated and supervised, which should improve their reliability and financial soundness. But this is not a foolproof guarantee of no risk, no loss. The financial crisis that started in 2007 provides ample evidence to the contrary.

Besides the regulation and supervision of intermediaries maintaining securities account, it is clear that the commercial law principles that dealt with certificated securities needed to be supplemented, if not replaced, by new rules dealing with immobilised or dematerialised securities, or rather with securities held through the intermediary holding system. In some jurisdictions, such as Belgium,[2] Luxembourg,[3] France[4] and the United States,[5] the legislature quickly stepped in. In some others, such as

2 *Arrêté royal n° 62 du 10 novembre 1967 favourisant la circulation des instruments financiers fongibles*; see also Chapter 9 of this book by Michel Tison and Lientje Van den Steen.

3 *Règlement grand ducal du 17 février 1971 concernant la circulation de valeurs mobilières*, replaced by the *Loi du 1er août 2001 concernant la circulation de titres et d'autres instruments fongibles*. This is soon to be supplemented, according to a Bill (*Projet de loi relative aux titres dematerialises*, n°6327) of 12 September 2011 now pending before the Luxembourg Parliament.

4 *Décret n° 83–359 du 2 mai 1983 . . . relatif au régime des valeurs mobilières*. The relevant provisions are now codified in the *Code Monétaire et Financier* at Arts. L211–1 et seq.

5 An initial revision of 1977 was replaced in 1994 by the current version of Art. 8 ('Investment Securities'), which has been enacted in all fifty-one states and adopted by the Federal Reserve Board to regulate the clearing and settlement system for the federal government's bonds.

Switzerland,[6] new statutory provisions were implemented only recently, or are presently being considered.

These new provisions deal with all or some of the following issues:

- What is the legal meaning of a credit of securities to a securities account? Is it merely evidential? Or does it represent or somehow contain rights against the relevant issuer, as did certificated securities before?
- Who should enjoy the rights attached to the securities? Any account holder to whose account such securities are credited? Or only the ultimate account holder down the pyramid, i.e. one who does not act as an intermediary for a further account holder?
- What steps are required for a credit to a securities account to be effective against the bank maintaining the account? Are additional steps required for the rights to become effective against the issuer and against third parties? Are such rights also effective in case of insolvency of the bank?
- Is a credit to a securities account the only way to acquire securities held through the intermediary holding system (let us call them intermediated securities, for convenience)? Is a debit the only way to dispose of intermediated securities? Can they be pledged to the intermediary or to a third party in some other way than by having them credited to a securities account in the name of the collateral taker? Which steps are necessary for such dispositions to become effective against third parties and against the insolvency administrators of the collateral provider?
- What happens if a debit to a securities account was not authorised by the account holder? Is the acquirer in that transaction protected? Is knowledge or lack thereof (bona fide) relevant? Must one party lose whenever the other wins, or are there circumstances in which both are protected and it is for the intermediary to make up for the missing securities?
- Until what point can an instruction to transfer intermediated securities be revoked by the transferor? What if the transferor is pronounced insolvent before the transfer has been completed? For systemic reasons, can the rules of a securities settlement system modify the legal rule on that issue?
- Can transfer orders and their respective credits and debits be netted, so as to be settled on a net basis?

6 Federal Intermediated Securities Act of 3 October 2008; see Chapter 13 of this book by Hans Kuhn.

- Can credits be made conditionally, so that they can be reversed if the relevant condition is not fulfilled? Does this apply to credits made before the settlement date if the transfers are not settled?
- Can an investor's securities be attached with any intermediary other than the one maintaining that investor's securities account? What are the effects of an attachment notified to a CSD instead?

It would not be very difficult to expand that list over the next three pages, but that is not the purpose of this chapter.

Our point here is to note that these numerous issues connected with the intermediary holding system are likely to be regulated in one way or another in most jurisdictions, but unlikely to be regulated in the same way. If Canadian investors only held securities issued in Canada, and Greek securities were only in the hands of Greek residents and institutions, this would bother nobody except perhaps for a few highly specialised scholars of comparative law. But such is not the case. Bonds issued by the Greek government are held by many investors outside of Greece, and Canadian investors hold, personally or via investment funds or pension funds, significant stocks of non-Canadian securities. In short, the globalisation of the financial markets has resulted in very significant cross-border holdings. A good example is offered by Swiss banks, which traditionally hold internationally highly diversified portfolios of securities for resident and non-resident clients.[7]

In short, besides the legal (and operational) risks associated with investors holding domestic securities through domestic intermediaries, cross-border situations give rise to additional legal (and operational) risks.

1.3 The governing law issue

The first obvious risk relates to the determination of the applicable law in cross-border holdings. When a Canadian investor sells Greek bonds to a Caiman Island vulture fund, which law governs the questions listed above and some others? The same question also applies when that same Canadian investor uses US Treasury bills as security for a loan extended by a Japanese bank.

7 At the end of April 2012, securities held by all clients with Swiss banks were valued at CHF 4,281 billion, of which 58.6% were issued by foreign issuers. Non-resident (individual and institutional) clients held a higher proportion of 70.8% of foreign-issued securities. Source: Swiss National Bank, *Monthly Statistical Bulletin*, June 2012, Table D52a.

The need for a clear rule of conflict was identified and discussed abundantly in the 1990s.[8] As early as 1998, the European Community adopted the 'place of the relevant intermediary approach' (PRIMA). For example, Article 9(1) of the Financial Collateral Directive refers to 'the law of the country in which the relevant account is maintained'.[9] Similar rules are mentioned in two other directives.[10] These directives achieved a fair degree of European Union-wide harmonisation, even though their respective scopes remain partial and the national provisions implementing those directives are not identical, and may thus provide diverging answers in some cases.

But cross-border holdings are not confined to the European Union. Considering the significant legal risk created by the diversity and sometimes uncertainty of the relevant rules of conflict, the Hague Conference on Private International Law took up that very issue in an expedited project.[11] Initiated in 1999, the project resulted in a diplomatic conference held in October 2002 which adopted the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.[12] This 'Hague Securities Convention' is dated 5 July 2006, being the day when the US and Switzerland formally signed the Convention.[13]

While the initial work of the Conference essentially followed the same lines as the then recent European directives, the approach was changed. Careful analysis showed that a purely objective test yields uncertain results when the relevant intermediary maintains securities accounts using a global platform or extensive outsourcing. In such situations, where is a

8 Guynn et al., *Modernizing Securities Ownership, Transfer and Pledging Laws*; Potok et al., *Cross Border Collateral: Legal Risk and the Conflict of Laws.*

9 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (FCD). See also below pp. 38 et seq. and se et seq.

10 Art. 24 of the Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (WUD); Art. 9(2) of the Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (SFD), as amended by Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009.

11 Bernasconi, *The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems*, Preliminary Document No 1 of November 2000, especially at 30 et seq.

12 Hague Conference on Private International Law, Proceedings of the Nineteenth Session (2002), tome II: Securities, 2006.

13 The Hague Securities Convention is not yet in force because it has been signed by three states (Mauritius, Switzerland and US) but ratified only by the first two. It nonetheless became part of Swiss statutory law on 1 January 2010.

particular securities account maintained? Is it the place of the branch where the client opened her account? Is it the place where the computers and the back-office people do the heavy work of keeping the databases and electronic accounts? Is it the branch that maintains the commercial relationship with the client, advising her and taking her securities order? Wherever is the best choice as the 'place of the relevant intermediary', is it sufficiently recognisable and stable so that the determination of the governing law is stable and predictable? Faced with these difficulties, the Conference departed from the original test and embraced a primary rule based on a designation of the governing law in the securities account agreement subject, however, to the rule that this designation is only effective if the intermediary has (or appears to have) actual securities account operations in the state whose law is designated in the account agreement.[14]

The consensus which allowed the finalisation and adoption of the text of the Hague Securities Convention during the 2002 diplomatic conference turned out to be short-lived. Important Member States of the European Union and the European Central Bank quickly raised objections against the Hague rule. Since the ratification of the Convention would need the approval of the European institutions and of the parliaments of each of the twenty-seven Member States, there is not much chance that such unanimity will be reached any time soon. Recently, the EU Commission has suggested that the present rule could be supplemented so as to clarify the result where multiple branches are concerned.[15] It has also been suggested that the expanded provision might be part of a regulation rather than a directive, noting that regulations are not implemented by national legislation, and are thus less prone to diverging interpretations.

However unfortunate the present situation, it is fair to say that the Hague rule and the European rule are likely to produce identical results in most situations.[16] This is because, for many reasons, banks and other financial intermediaries want the (money and securities) accounts they maintain for their clients to be governed by the law of the place of the establishment with which the client has his business relationship. It is

14 See Art. 4 of the Hague Securities Convention; Art. 5 contains fall-back rules.

15 'Where an account provider has branches located in jurisdictions different from the head offices' jurisdiction, the account is maintained by the branch which handles the relationship with the account holder in relation to the securities account, otherwise by the head office.' See Principle 14.2 of the EU Consultation Paper, presented below in section 1.6.

16 See also 'Legal assessment of certain aspects of the Hague Securities Convention', Commission Staff Working Document of 3 July 2006, SEC(2006) 910.

very unlikely that an intermediary would be willing to operate a securities account in one jurisdiction under the rules of another jurisdiction. There is such a deep connection between the commercial law governing the account and the regulatory framework, which is essentially territorial, that intermediaries are unlikely to take the risk of submitting the account to any other law.

Once the conflict of laws uncertainty had been sorted out – if not by a uniform rule, at least by a better understanding of the existing approaches and their respective outcome – the international focus shifted to the diversity and mismatches among the substantive laws governing intermediated securities. This project was taken up in 2002 by the Institute for the International Unification of Private Law (UNIDROIT) in Rome, and resulted in the UNIDROIT Convention on Substantive Rules for Intermediated Securities being adopted in 2009 by a diplomatic conference convened in Geneva, henceforth known as 'the Geneva Securities Convention'.

1.4 A brief history of the Geneva Securities Convention

Why should the substantive law of intermediated securities be harmonised? And to what extent? These were the first questions addressed by a restricted study group meeting for the first time in September 2002 in Rome.

The study group's provisional answer was released for public discussion in a position paper dated August 2003.[17] The following paragraphs summarise the group's thinking at the time:

> The issues at stake can be divided into two categories –
>
> – The first category is internal soundness, which comprises issues relating to the key features which any structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, bearing in mind in particular the objectives of investor protection and efficiency.
> – The second category is compatibility, which comprises issues affecting the ability of different legal systems to connect successfully where securities are held or transferred across national borders.

17 'The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities', Position Paper, UNIDROIT 2003 – Study LXXVIIII – Doc. 8, August 2003. All documents relating to that project are available from the UNIDROIT website, www.unidroit.org.

> A harmonised rule should be regarded as appropriate if, but only if, it is clearly required to reduce legal or systemic risk or to promote market efficiency. This approach recognises that, desirable though it may be in principle to achieve harmonised rules, in practice this is a complex and difficult process that requires both technical and political consensus. The difficulty of achieving this, particularly within a reasonable timeframe, strongly argues in favour of a restrictive approach to the scope of harmonization. Furthermore, a functional approach should be adopted, that is, one which uses language which is as neutral as possible and which formulates rules by reference to their results.[18]

It is worth noting that the core principles set out here guided the whole process up to the adoption of the Convention. We will shortly revisit them in the next section. The position paper identifies the following issues for which harmonisation, or some degree of it, is needed:

- prohibition of attachment at an upper tier;
- legal requirements for a valid transfer;
- creation and realisation of security (collateral) interests;
- availability of non-harmonised disposition methods;
- protection of good faith acquisition;
- effectiveness of net settlement;
- finality and irrevocability;
- possibility of provisional credits;
- allocation of shortfall;
- protection in insolvency.

All those points are part of the final text of the Convention. But some other important issues were later identified in the process and are also part of the Convention.

The restricted study group had the benefit of numerous comments to the position paper and attracted the interest of the financial regulators and of the financial industry. With the support of UNIDROIT's Secretariat, its members made fact-finding visits to various countries, the results of which fed back into the thinking of the group. Altogether in four sessions over two years, the group came up with a draft instrument.[19] This draft served as the starting point for negotiations that were handled by a Committee of Governmental Experts convened by the Governing

18 *Ibid.*, at 5–6.

19 Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary, Explanatory Notes, UNIDROIT 2004, Study LXXVIII – Doc. 19, December 2004.

Council of UNIDROIT. The Committee held four sessions, from May 2005 to September 2007. Its progress was supported by inter-sessional working groups, seminars, and consultations. Its work (drafts, working papers, comments by delegations and observers, minutes) is thoroughly documented on the UNIDROIT website.[20]

This book is not about the history of the Convention. It is nonetheless useful to recall some of the most significant issues that were only properly identified during the work of the Committee and attracted a lot of attention and concern until they could be solved.

1. So-called 'transparent systems' are intermediated holding systems where the investor accounts are maintained by the CSD or where the CSD by some other means actually identifies investors. Such systems exist in emerging markets (notably China and Brazil) and in mature markets (Spain, Nordic countries). At the second session of the Committee of Governmental Experts, serious doubts were raised whether such systems could actually fit into the draft Convention. Extensive research and dialogue followed that session, resulting in a ground-breaking working paper which allowed the Committee to give full consideration to the issues raised by transparent systems and make sure that the Convention would include them.[21]
2. In most systems, only regulated intermediaries are allowed to maintain securities accounts for clients. This legal requirement is supported by the idea that intermediaries maintaining such accounts bear a huge responsibility in respect of their clients' holdings as well as the systemic stability of the whole system. Some official supervision and review of their operation is an important support to the application of sound commercial rules. Should that disqualify clients of unlicensed intermediaries from enjoying the benefits of the Convention? A number of delegations thought that it should, a possibility now offered to Contracting States.[22]
3. The means by which the total number of securities circulating in the intermediated holding system matches the number of securities that

20 At www.unidroit.org.

21 Report of the Transparent Systems Working Group, UNIDROIT 2007, Study LXXVIII – Doc. 88, May 2007. That work resulted, inter alia, in the addition of Art. 7 (Performance of functions of intermediaries by other persons) of the Convention and by an attenuation of its Art. 22 (Prohibition of upper-tier attachment).

22 See Art. 5(b) of the Convention.

were actually issued are a topic of constant debate.[23] How it is to be achieved is linked closely with fundamental issues of property law (whether an investor actually and individually owns the securities she has bought, or whether she owns an interest in the pool of like securities held by its intermediary), corporate governance (number of voting rights that can be exercised), and protection in the insolvency of an intermediary. Articles 21 to 28 of the Convention represent a compromise solution to this issue. One side-effect of this debate is that a uniform rule confirming the validity of transfers of intermediated securities that are processed on a net basis was replaced by a neutral statement to the effect that the Convention does not stand in the way of any such national rule.[24]

4. A list of internationally harmonised methods for disposing of intermediated securities or some interest therein was present from the very start. It was clear that, while credits and debits to securities accounts are and must be universally available, other methods are optional for Contracting States. The Committee of Governmental Experts made three fundamental changes to the original proposal, the result of which is now in Article 12 of the Convention. First, the Committee expanded the list of optional methods to include control agreements.[25] Second, the menu approach, whereby each Contracting State may choose to apply one, more, or none of the optional methods, was supplemented by a declaration to be made by the relevant state so as to give some degree of international publicity to the methods available under the laws of that state. Third, and perhaps most important, the Committee recognised that each method should be available for any type of disposition, whether it is an outright transfer, a collateral transaction, or the creation of yet another type of interest (such as usufruct or a trust).

Eight weeks of meetings of the Committee of Governmental Experts, supplemented by numerous inter-sessional working groups and consultations, transformed and enriched the initial draft of December 2004. In

23 See Chapters 7 (Charles Mooney) and 8 (Hubert de Vauplane and Jean-Pierre Yon) in this book.

24 Compare Art. 11(5) of the Convention with Art. 3(4) of the Preliminary Draft Convention, UNIDROIT 2004 Study LXXVIII – Doc. 18, November 2004.

25 Control agreements and designating entries now seem to compete. Because dispositions must be effective against third parties, some states concerned with the lack of publicity toward third parties of interests perfected through control agreements obtained the possibility that their priority rule may derogate from a strict *prio tempore* principle and give preference to interests perfected by way of a designating entry. See Art. 19(7).

2007, UNIDROIT's Governing Council considered that the project was ripe for diplomatic conference. The conference was hosted by the Swiss Government in Geneva during the first two weeks of September 2008. The crisis of the financial markets was developing on a daily basis – the failure of Lehman Brothers (which filed in bankruptcy court on 15 September 2008) occurred only three days after the first session of the conference ended.

Ten days of work by delegates of fifty-two states and by observers of the European Community and eleven international organisations and groups allowed a first and a second reading of the full text of the Convention, but did not result in its adoption. Delegations were keenly aware of the unusual complexity of the instrument and of its technicality. They wanted more time to better understand the implications of the text that had been arrived at. To help them in this assessment, the conference requested that a draft Official Commentary be prepared and circulated at least three months before a second session be convened.[26]

That final session was held in Geneva in October 2009, at the end of which the Conference adopted the UNIDROIT Convention on Substantive Rules for Intermediated Securities, Resolution No 1 of which recommends that it be known as the 'Geneva Securities Convention'.[27]

The Official Commentary was subsequently supplemented, circulated for comment, finalised and published.[28] Besides an emerging literature on the subject, the Official Commentary is the main source of information on the policy discussions and drafting issues considered during the whole process leading up to the adoption of the Convention.

1.5 Objectives and guiding principles of the Convention

As far as conventions harmonising a particular topic of private law are concerned, there are hardly any as complex as the Geneva Securities

26 See the Final Act of the first session of the diplomatic Conference to Adopt a Convention on Substantive Rules regarding Intermediated Securities held under the auspices of the International Institute for the Unification of Private Law in Geneva from 1 to 12 September 2008, including Resolution No. 2 relating to the Official Commentary on the Convention.

27 Final Act of the final session of the diplomatic Conference to Adopt a Convention on Substantive Rules regarding Intermediated Securities held under the auspices of the International Institute for the Unification of Private Law in Geneva from 5 to 9 October 2009.

28 Kanda et al., *Official Commentary on the Unidroit Convention on Substantive Rules for Intermediated Securities*, also published in French as *Commentaire officiel de la Convention d'Unidroit sur les règles matérielles relatives aux titres intermédiés*.

Convention. That complexity has many reasons. The sheer technicality of the topic is one. Another is the huge diversity of legal and technical arrangements on which national systems for the intermediated holding of securities developed over time. That complexity should not however hide its objectives and guiding principles, which this section attempts to sketch out with a broad brush.

Whereas the Hague Securities Convention contains rules of conflict, the Geneva Securities Convention deals exclusively with substantive rules. It often refers to the 'non-Convention law'[29] or to 'the applicable law', but never purports to designate which law, besides its own provisions, should govern any particular issue.

The subject matter of the Convention, 'intermediated securities', is not a pre-existing concept. In fact, it is a new term of art defined in Article 1(b) as 'securities credited to a securities account or rights or interest in securities resulting from the credit of securities to a securities account'. The Convention provides substantive rules for securities when they are credited to a securities account maintained by an intermediary. How the securities were issued – certificated securities, jumbo certificate or fully dematerialised securities – is irrelevant to the operation of the Convention, as long as the securities are kept within the intermediated holding system.[30]

The Convention has three fundamental objectives: protecting the rights of investors, preserving the integrity of the intermediated holding system, and ensuring the cross-border compatibility of legal systems. However, the breadth and depth of its provisions are much more limited than these objectives would suggest. Most of its provisions read like principles, expressed in terms of a result to be achieved, rather than a prescription for how to achieve it. Why is this so?

One of the main reasons for the complexity as well as the limitations of the Convention lies with the recognition that the global intermediated holding system is actually a complex network of as many different systems as there are jurisdictions and markets. The legal, commercial and technological elements of each system are heavily dependent on how it developed

29 Defined in Art. 1(m) of the Convention. On this topic, see particularly Garcimartín Alférez, 'The Geneva Convention on Intermediated Securities: a Conflict-of-Laws Approach'.

30 Art. 9(1)(c) of the Convention states that 'to the extent permitted by the applicable law, the terms of the securities and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system' decide whether securities can be held otherwise than through a securities account.

and, to an amazing extent, on the fundamental doctrines of property that underpin its design and evolution. The mixed nature of securities before their intermediation, intangible property transmuted into chattels, gave rise to very different legal characterisation of the rights arising from the immobilisation or dematerialisation of the securities and their credit to securities accounts.[31]

It was soon acknowledged in the preparatory work that no instrument harmonising the law of intermediated securities would be acceptable if it implied interfering with basic national doctrines of property law. This is why the design of the Convention follows a functional approach.[32] Rules are drafted by reference to facts and results; they avoid in so far as possible legal notions.[33] For example, while the Convention is essentially about the property of investors in respect of intermediated securities, it almost entirely omits the word itself.

In addition, it soon became apparent that in these matters, less is more. For example, it was obvious that fully harmonising the validity requirements for book entries would be impossible. As a result, the Convention requires that the intermediary acts upon an instruction authorised by the account holder or by the law, and states emphatically that no further step than a credit or a designating entry is necessary to make the acquisition effective against third parties. The harmonisation goes no further and leaves other validity requirements for 'non-Convention law', the shorthand for the applicable law besides the Convention itself.[34]

A common criticism is that the Convention defers so often to the non-Convention law that it fails to achieve any meaningful degree of harmonisation. The Official Commentary itself speaks of a 'minimalist' approach.[35] The Convention falls far short of a uniform set of rules that would apply irrespective of the law governing a given securities account. It offers many options, and for the most important ones requires that the choices be publicised by a declaration by the relevant Contracting

31 See Chapter 2 by Philipp Paech in this book; see also Thévenoz, 'Intermediated Securities', at 401 et seq.

32 See the 6th recital of the Preamble.

33 The *Official Commentary*, at Int-20, speaks of a 'a functional and neutral approach.' See particularly Than, 'Der funktionale Ansatz in der UNIDROIT Geneva Securities Convention vom 9. Oktober 2009'.

34 Kronke, 'Das Genfer UNIDROIT-Übereinkommen über materiellrechtliche Normen für intermediär-verwahrte Wertpapiere und die Reform des deutschen Depotrechts'; Deschamps, 'The Geneva Securities Convention – Selected Issues Left to Law Outside the Convention'.

35 *Official Commentary*, Int–21.

State. But this self-limiting approach to harmonisation must be seen as the only chance of its success. Any more would be outright unacceptable. This does not prevent more extensive harmonisation at a regional level.

1.6 The ongoing EU harmonisation process

An international convention designed to support enhanced harmonisation at regional level was not an abstract idea. Early on in the UNIDROIT project, the European Union set upon assessing the need, ways and means for further and deeper harmonisation.[36]

In 2005, the EU Commission appointed a group of experts, the so-called Legal Certainty Group, which embarked on an extensive and detailed review of the laws of Member States as well as of some other significant jurisdictions (Japan, Switzerland, the United States). The compiled results make for an impressive 666-page document.[37] The group also produced a number of interesting topical papers. Its main output is however a short first advice,[38] released together with the comparative compilation mentioned above, followed two years later by a second (and final) advice.[39]

Based on these advices, the Commission began preparing draft legislation. A Consultation Document was circulated in April 2009, which obtained a broad audience and numerous comments.[40] Further internal documents were then prepared. At the time of the conference in which

36 The first report of the committee chaired by Alberto Giovannini ('Cross-Border Clearing and Settlement Arrangements in the European Union', November 2001) had earlier concluded (at 54) that 'the existence of different legal rules defining the effect of the operation of a system, including different legal structures concerning securities themselves' are significant barriers to efficient cross-border clearing and settlement, and thus obstacles to the extension and deepening of the single market for securities and investment services. The report also noted that 'Barriers relating to legal certainty are of a different order to the others, as they cannot be removed without affecting basic legal concepts' (*ibid.*) As noted above when discussing the 'functional' and 'minimalist' approaches, the UNIDROIT harmonisation project relied on the tenet that harmonised rules should interfere as little as possible with such basic legal concepts.

37 Document MARKT/G2/MNCT D(2005), 26 July 2007.

38 Legal Certainty Group, 'EU Clearing and Settlement', Advice, dated 11 August 2006.

39 Second Advice of the Legal Certainty Group, 'Solutions to Legal Barriers related to Post-Trading within the EU', August 2008.

40 Directorate-General Internal Market and Services, 'Legislation on Legal Certainty of Securities Holding and Dispositions', Consultation Document G2/PP D(2009), 16 April 2009.

this book originates,[41] participants generally had access to an 'Updated Compilation of the rules and explanatory notes discussed so far', prepared in September 2010.[42] While the circulation of the document was limited to a working group of Member States, the sheer number of persons involved in the work, and the extraordinary interest that it raised, resulted in a near-public dissemination.

While this 'Updated Compilation' was certainly on the mind of the speakers in Luxembourg, their chapters in this present book can now refer explicitly to the officially published subsequent Consultation Document, released by the Services of the Directorate-General Internal Market and Services in November 2010,[43] and to the summary of responses that was made available in May 2011.[44] This is why, when referring to the ongoing legislative process, the authors of this book have generally referred to the EU Consultation Document of November 2011.

The adoption of a proposal by the EU Commission has been deferred many times. Other burning issues took priority in the legislative agenda of Mr Barnier, the Commissioner for Internal Markets, and of the Commission itself. The editors of this book decided that they should wait no longer and proceed with its publication, even though there is not yet an actual draft piece of EU legislation that can be discussed. It is hard to know whether and when such a draft will be adopted by the Commission, whether it will be a directive or a regulation (the favoured approach recently, it seems), or whether it will incorporate and supplement the Geneva Securities Convention or contain rules that would be incompatible with it and would actually prevent the European Union and its Member States from signing and ratifying the Convention.

41 'Intermediated Securities – The Geneva Securities Convention, the European Securities Law Directive and their Impact on Securities Laws of Selected European Jurisdictions', Luxembourg, 23–4 September 2010. The conference was organised by the Faculty of Law, Economics and Finance of the University of Luxembourg jointly with the Centre for Banking and Financial Law of the University of Geneva.

42 Directorate-General Internal Market and Services, 'Legislation on Legal Certainty of Securities Holding and Dispositions, Member States Working Group, Updated Compilation of the rules and explanatory notes discussed so far', G2/PhP D(2010), 17 September 2010.

43 Directorate General Internal Market and Services, 'Legislation on Legal Certainty of Securities Holding and Dispositions', Consultation Document DG Markt G2 MET/OT/acg D(2010) 768690 [November 2010], available at http://ec.europa.eu/internal_market/consultations/2010/securities_en.htm.

44 'Legislation on Legal Certainty of Securities Holding and Dispositions, Summary of Responses to the Directorate-General Internal Market and Services' Second Consultation' [May 2011].

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