Memorandum Regarding the Uniform Version of Article 8 of the Uniform Commercial Code and the Treatment of Investment Property Under the Uniform Version of Article 9, with Addenda Regarding Federal Book-Entry Regulations and International Developments

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I. Introduction and Background

The Uniform Commercial Code (the "UCC"), a product of joint efforts by the American Law Institute ("ALI") and the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), consists of eleven articles, the first of which sets forth certain general provisions and the second through eleventh of which provides rules for various types of commercial practices. Article 8 governs investment securities and Article 9 governs security interests in personal property. This set of uniform laws, which is periodically revised to respond to developments in the law and commercial practice, has no effect until adopted by the relevant legislative body. In 1994 the ALI and NCCUSL approved a major revision of Article 8, and in 2001 a major revision of Article 9. In each case conforming amendments were made to other articles. Revision of the prior version of Article 8 of the UCC had been urged for several years, and the revisions were considered to represent a major advance in commercial law, particularly in addressing computerized recordkeeping and global securities trading. Similarly, revisions to Article 9 were widely supported. The uniform version of Article 8 is in effect in all fifty States and the District of Columbia and Puerto Rico, and with certain exceptions not relevant to this memorandum, the uniform version of Article 9 insofar as it applies to investment property is also in effect in all fifty States and the District of Columbia. n1

n1 See www.ali.org and www.nccusl.org for more information on these bodies and their work.

The prior version of Article 8 had assumed the evolution of a system in which issuers would no longer issue certificates. n2 Hence, parallel provisions dealing with uncertificated securities were established. Both the certificated and uncertificated provisions of the 1978 amendments contemplated that the beneficial owners of securities would often have a direct relationship with the issuer of the securities, either by being the holder of a bearer instrument and thus having a direct claim against the issuer or by, in the case of registered securities, being recorded as the owner on the records maintained by the issuer or its transfer agent. n3 Other than in the case of mutual fund shares, however, a system of uncertificated securities did not develop. An extensive pattern of indirect holding developed instead. Certificates are still issued but tend not to be in the hands of the ultimate beneficial owners. The securities are registered in the name of, and immobilized with, clearing corporations and other depositories. The depository's books in turn show the identity of the banks or brokers that are its
members, and the records of those intermediaries identify their customers. (See Diagram 1)

n2 Prefatory Note to Article 8, at 2.

n3 Prefatory Note to Article 8, at 4.

The prior version also included outdated choice of law rules, based in large part on where a physical security certificate was located, which often resulted in the application of the law of a jurisdiction that most market participants considered irrelevant. The UCC now provides choice-of-law rules in both the sale and security interest contexts that are keyed to the way in which the interest in the security is maintained.

The version of Article 8 now in effect was thus the result of the effort to overhaul current commercial law rules for investment securities to reflect the realities of modern securities holding practices. The revisions have also expanded the types of assets covered and deal directly with the nature of the property interest obtained by a purchaser of securities and other financial assets in the indirect holding system.

The UCC has therefore moved from an approach based on an attribute of the security itself (certificated vs. uncertificated), and reflects instead a distinction based on how the security is held. Under Article 8, the most significant distinction is whether one has a "direct" relationship with the issuer, as when one is a "record owner," or an "indirect" relationship, as when the investment is held through one or more intermediaries. Because the differences between the systems of direct and indirect holding are significant, the drafters determined that it would be better to treat them as separate systems requiring different legal concepts. n4 Article 8 classifies the system in which the owner has a direct relationship with the issuer as the "direct holding system;" the rules for this system (set out in Part 3 of the statute) apply only to securities, not a broader category of financial assets. The system in which interests in financial assets, including securities, are held through one or more intermediaries is classified as the "indirect holding system." Of course, the indirect system is not entirely independent of the direct system - in the case of securities, the entity at the top of the indirect chain will have a "direct" relationship with the issuer itself. n5

n4 Prefatory Note to Article 8, at 6.

n5 For various securities issued by the United States Treasury and other agencies and government sponsored organizations which are maintained in the form of entries in the records of Federal Reserve Banks, a system of federal regulation (commonly referred to as the "TRADES Regulations") intersects with the UCC. This memorandum will not deal directly with these regulations except to note that the issuer's obligations are governed by federal law and specific choice of law rules paralleling those in the UCC ensure that in other respects the UCC as in effect in the relevant state applies to these securities as well. See, e.g., 31 C.F.R. pt. 357 (later publications confirm that the limited, transitional preemptive effect of these regulations is not longer in effect). Information regarding these
regulations may be found on the website of the United States Treasury's Bureau of Public Debt (www.publicdebt.treas.gov/cc/cctrades.htm).

The recently adopted (and enacted) revisions to Article 9 brought along few substantive revisions to the treatment of investment property as collateral, and for the most part simply integrated the investment property provisions (that had been contained in a single section) into the revamped structure of the Article. n6

n6 The revisions did make some substantive changes, however, including refinements of the priority and choice of law rules, which are reflected in the summary provided below.

II. Selected Terminology

Certain terminology in the UCC is critical to a basic understanding of the relationship between the indirect and direct holding systems and the various relationships among parties having interests in securities and financial assets. Set forth below are some of the key terms.

As a preliminary matter, it is important to note that the term "purchaser" is used in the UCC to include a person who takes by any voluntary transaction creating an interest in property -- including sale, security interest, issuance and gift, among other methods. See Sections 1-201(32),(33). n7

n7 The term "Control" means that a purchaser (which term includes secured parties as well as buyers) has taken whatever steps are necessary, given the manner in which assets are held, to place itself in a position where it can have the assets sold, without further action by the original owner. Official Comment 1, Section 8-106.

- Control of bearer securities is obtained by delivery. Section 8-106(a).

- Control of certificated securities in registered form requires delivery as well as either effective indorsement to the purchaser or in blank (Section 8-106(b)(1)) or registration of transfer by the issuer (Section 8-106(b)(2)).

- Control of uncertificated securities requires delivery (Section 8-106(c)(1)) or obtaining an agreement pursuant to which the issuer agrees to act on instructions from the purchaser without further consent from the registered owner (Section 8-106(c)(2)).

- Control of security entitlements occurs when the purchaser becomes the entitlement holder itself or if it obtains the agreement of the securities intermediary and the entitlement holder to comply with instructions of the purchaser, without further consent by the entitlement holder. Section 8-106(d). The statute also specifically recognizes that an entitlement holder's
own securities intermediary has control over the security entitlement of the entitlement holder. Section 8-106(e).

The statute makes clear that control can be obtained directly by a purchaser or through another person acting on behalf of the purchaser.

The term "Delivery" is defined in Section 8-301 depending on the form in which the security is held.

- Delivery of certificated securities occurs (a) when a purchaser acquires possession of a security certificate or (b) a person (other than a securities intermediary) acquires possession of the certificate on behalf of the purchaser or, if having previously acquired possession, acknowledges that the certificate is held for the purchaser. Section 8-301(a)(1) and (a)(2). If a securities intermediary is involved, the certificate must be in registered form and may not be indorsed to the intermediary or in blank (when held by an intermediary a bearer security or a security so indorsed would be considered part of the indirect system).

- Delivery of uncertificated securities occurs when (a) the issuer registers the purchaser as the registered owner or (b) a person (other than a securities intermediary) becomes the registered owner thereof on behalf of the purchaser or, if having previously become the registered owner, acknowledges that it holds for the purchaser. Section 8-301(b).

The term "Adverse claim" is defined in Section 8-102(a)(1) as "a claim that the claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset." The term refers only to property interests and requires that the claimant's property interest be violated by another person's holding or transferring of the security (or other financial asset). The term clarifies an ambiguity in Section 8-302 of the prior version of Article 8 that suggested that any wrongful action concerning a security, including a simple breach of contract, gave rise to an adverse claim. See Fallon v. Wall Street Clearing Corp., 586 N.Y.S.2d 953, 182 A.D.2d 245 (1992) and Pentech Intl. v Wall St. Clearing Co., 983 F.2d 441 (2d Cir. 1993) (which decisions were based on this broader view and are rejected by the new definition). The term is not limited to ownership rights but also covers security interests and other property interests established by law.

The concept of "Notice of adverse claim" is defined in Section 8-105 to be actual notice or willful blindness. n8 A person will be charged with notice of an adverse claim if the purchaser "has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim." Section 8-105(a)(3).
The term "Value" is defined in Section 1-201(44) includes, inter alia, any consideration sufficient to support a simple contract (including, e.g., past extensions of credit).

The term "Collusion" is not defined in the statute but is stated to be "intended to adopt a standard akin to the tort rules that determine whether a person is liable as an aider or abettor for the tortious conduct of a third party." Official Comment, Section 8-115 (citing Restatement (Second) of Torts § 876).

The term "Security entitlement" is defined in Section 8-102(a)(17) as the "rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5," discussed in Part IV below.

The term "Securities account" is defined in Section 8-501(a) as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." n9

The term "Securities intermediary" is the term used for those who hold securities for others in the indirect holding system. It is defined in Section 8-103(a)(14) as a clearing corporation or a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity. n10

The term "Entitlement holder" refers to the one who holds financial assets through a securities intermediary and is defined in Section 8-103(a)(7) as "the person identified in the records of a securities intermediary as the person having a securities entitlement against the securities intermediary."

The term "Security" means an obligation of an issuer or share, participation or other interest in an issuer or its property, which is certificated or uncertificated, is one of a class or series and which:

(i) is of a type dealt in or traded on securities exchanges or securities markets; or

(ii) is a medium for investment and expressly provides that it is a security governed by Article 8.

Section 8-102(a)(15). A security includes a share or equity interest issued by a corporation, business trust, joint stock company, investment company or similar entity.
Section 8-103 provides explicitly that an interest in a partnership or limited liability company is a security if (i) it is dealt in or traded on securities exchanges or in securities markets (being "of a type" is not available for partnership/limited liability company interests), (ii) is stated expressly to be governed by Article 8 or (iii) is an investment company security.

The definition of security in the UCC does not restrict the scope of Article 8. The direct holding system rules in Parts 2, 3 and 4 are limited to securities, but the indirect holding system rules of Part 5 apply to the broader category of "financial assets."

n7 Article 1 of the UCC has been revised, but very few states have enacted it to date and therefore references in this memorandum to sections of Article 1 and to the version currently in effect in the State of New York.

n8 Specifically, Section 8-105 provides that "the person is aware 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."

n9 A broker might offer customers an arrangement in which a customer has access to money market shares held in its securities account via a deposit account with a bank, whereby shares of the money market fund are redeemed to cover checks drawn on the account. Article 8 applies only to the securities account, and the linked bank account remains an account covered by other law.

n10 For technical reasons, the term "broker" is defined separately.

The term "Financial asset" includes:

(i) a security;

(ii) an obligation of or in a person or in property of a person which is of a type dealt in or traded on financial markets or recognized in any area in which it is issued or dealt in as a medium for investment; or

(iii) any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under Article 8.

III. Parts 2, 3 and 4 of Article 8

The rules of Parts 2, 3 and 4 of Article 8 deal only with the rights of persons who hold securities directly. In today's indirect holding system patterns, the direct holders are typically clearing corporations. In such circumstances, Parts 2, 3 and 4 have no
application to relationships below the clearing corporation level, and will be dealt with only briefly in this memorandum.

A. Part 2 Rules.

These rules deal principally with certain aspects of the obligations of issuers. The primary purpose of these rules is to apply to investment securities the principles of negotiable instruments law that preclude issuers of negotiable instruments from asserting certain defenses against subsequent purchasers. These rules are largely unchanged from the prior version of Article 8.

B. Part 3 Rules.

These rules address the transfer of securities held directly. One of the primary purposes of the Part 3 Rules is to apply to investment securities the principles of negotiable instruments law protecting purchasers of negotiable instruments against adverse claims. As a result of the addition of Part 5 to deal with the indirect holding system, the elaborate transfer provisions in the prior version of Article 8 became unnecessary.

Part 3 also combines, where appropriate, the rules for certificated and uncertificated securities so that differences are not overemphasized and to emphasize that the key attribute of ownership of a security was not its certificated/uncertificated status but the difference in method by which ownership is evidenced. n11

n11 Consistent with this approach, Section 8-102(a)(15) adopts a unitary definition of security which refers to the underlying intangible interest or obligation.

With respect to uncertificated securities, Part 3 eliminates the need for transaction statements and registered pledges. n12 The deletion of the provisions relating to registered pledges does not mean that issuers cannot offer such a service. The control rules of Section 8-106 of the UCC and the related priority provisions in Article 9 establish a structure that permits issuers to develop systems akin to the registered pledge device without mandating that it be done or providing the details.

n12 The prior version of Article 8 required that issuers of uncertificated securities send out transaction statements to various persons upon registration of transfer and at other specified times. This was considered an unnecessary intrusion of commercial law into market practice and therefore deleted.

One of the key changes to Part 3 is the revision of the concept of "bona fide purchaser." The revised UCC term for "bona fide purchaser" in Article 8 is "protected purchaser." Section 8-303 of the UCC defines a protected purchaser as a purchaser of a certificated or uncertificated security who gives value, does not have notice of any adverse claims to the security and obtains control of the certificated or uncertificated security. n13 To qualify as a protected purchaser, "there must be a time at which all of the requirements are satisfied." n14 Section 8-105 eliminates any separate requirement of "good faith" that was formerly an element of "bona fide purchaser" status.
n13 This is parallel to Section 8-502 for the indirect holding system, as discussed below.

n14 Official Comment 2, Section 8-303.

Section 8-303 goes on to describe the benefits of being a protected purchaser: "In addition to acquiring the rights of a purchaser, a protected purchaser also acquires its interest in the security free of any adverse claims." Because of the breadth of the definition of "purchaser" in Section 1-201, a secured party in addition to an outright buyer can qualify as a protected purchaser.

C. Part 4 Rules.

Part 4 addresses the process of registration of transfer by the issuer or transfer agent. The key change from the prior version of Article 8 is that the issuer is not liable for wrongful registration of transfer if it acts on an effective indorsement or instruction, even though the issuer may have notice of adverse claims so long as the issuer has not been served with legal process and is not acting in collusion with the wrongdoer in registering the transfer. See Section 8-404 and Official Comment thereto. The provisions of the prior version of Article 8 specifying that issuers had a duty to investigate adverse claims of which they had notice were deleted. This provision parallels that applicable to the indirect system in Section 8-115, discussed below. The policy behind both provisions is to protect the right of investors to have their securities transfers processed without the disruption or delay that might result if the recordkeepers risked liability to third parties.

IV. Part 5 of Article 8

A. Coverage and Nature of Interest Acquired in the Indirect System.

As discussed above in Part II, by covering a wide variety of "financial assets," as well as a broader category of "securities," the scope of Article 8 of the UCC is fairly expansive. The aim was to create a statute capable of governing transactions in new types of investment assets yet to be invented by the market without further amendments. The applicability of Article 8 to financial assets that are not securities - e.g., mortgage loans, most partnership interests, certificates of deposit, etc. - will be triggered if such assets are held in a securities account, and therefore become part of the indirect holding system, described further below. n15 The direct relationship with the issuer of, or obligor on, such items remains governed by other law, e.g., UCC Article 3 for negotiable instruments.

n15 As noted in Part II, the instrument could also qualify as a financial asset if it is an obligation, share, participation or other interest which is, or is of a type, dealt in or traded on financial markets, or which is recognized in any area in which it is issued as a medium for investment.
When such assets are credited to a securities account, security entitlements are created. (A security entitlement can, in certain circumstances, also be acquired before the financial asset is actually credited to the securities account. n16) Part 5 sets out the package of rights and property interests that comprise the security entitlement acquired by the purchaser.

n16 See UCC Section 8-501(b). This would occur, for instance, if the securities intermediary receives a financial asset from, or acquires the financial asset for, a person and, in either case, accepts it for credit to the person's securities account. Also, if the securities intermediary becomes obligated under other law, regulation or rule to credit a financial asset to the person's securities account, the person would be treated as having a securities entitlement.

The extent and nature of the entitlement holder's interest in the assets held through a securities intermediary is set forth in a straightforward manner in Section 8-503:

To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511.

The statute thus makes clear that entitlement holders are much more than unsecured claimants: ". . . [a] security entitlement is itself a form of property interest not merely an in personam claim against the intermediary. The concept of a security entitlement does, however, include a package of in personam rights against the intermediary. Other Part 5 rules identify the core of this package of rights, subject to specification by agreement and regulatory law." n17 See Sections 8-505 through 8-509, discussed below.

n17 Prefatory Note to Article 8, at 9.

The interest of the ultimate beneficial owner does not, however, constitute a specific property interest in a specific asset. Insofar as the relationship among all entitlement holders of a single intermediary (i.e., "owners" who hold through (have a security entitlement with) the same intermediary) is concerned, Section 8-503 provides that an entitlement holder's property interest with respect to a particular financial asset "is a pro rata property interest in all interests in that financial asset held by the securities intermediary." To the extent there are not enough financial assets held by the securities intermediary, the entitlement holder would simply have a claim for any shortfall. If the intermediary is insolvent, special rules will apply and, to a certain extent, insurance will be available to satisfy customer claims. See, e.g., the Securities Investor Protection Act of 1970, as amended, 15 U.S.C. § 78aaa et seq. n18
This particular aspect of the indirect holding system rules was consistent with the situation under the prior version of the UCC for the vast majority of investors. (See, e.g., prior Section 8-313(2), which provided that where securities were held as part of a fungible bulk, the purchaser was the owner of a proportionate property interest in the fungible bulk.)

Related provisions do alter from former law the entitlement holder's relationship with other market participants, however. Perhaps most significant, the statute makes clear that, with limited exceptions, an entitlement holder's interest with respect to a particular financial asset may be enforced only against its securities intermediary, and not third parties. See Section 8-503(c) and (d).

In this respect, the UCC gives legal recognition to the realities of the modern securities holding system. First, each intermediary (generally) knows only the identity of its own customer and the extent of its position. Second, the indirect holding system is not based upon possession of a specific thing. "The idea that discrete objects might be traced through the hands of different persons has no place in the revised Article 8 rules for the indirect holding system. Rather, the fundamental principles of the indirect holding system rules are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the security, and therefore that an entitlement holder can look only to that intermediary for performance of the obligations." n19

n19 James Steven Rogers, Policy Perspectives on Revised UCC Article 8, 43 UCLA L. Rev. 1431, 1436 (1996).

B. Enhanced "Finality" in the Indirect Holding System.

As noted above, Section 8-503(c) provides that "[a]n entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against the securities intermediary only by exercise of the entitlement holder's rights under Sections 8-505 through 8-508." The negative inference one draws from this is made explicit in Section 8-503(e), which provides that "[a]n action based on an entitlement holder's property interest with respect to a particular financial asset . . ., whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser [including pledgees] of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504 [to maintain sufficient financial assets -- discussed below]."

The use of the collusion test in Section 8-503(e) is intended to permit the "sound and efficient operation of the securities holding and settlement system. The effect of the choice of this standard is that customers of a failed intermediary must show that the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct . . . . The rule of Section 8-503(e) is based on the longstanding policy that it is undesirable to impose upon purchasers of securities any duty to investigate whether their sellers [intermediaries acting on behalf of their customers] may be acting wrongfully." Official Comment, Section 8-503(e).
In addition to the requirement of collusion, in order for an entitlement holder's property interest to be enforceable against a purchaser of the financial asset (or interest therein),

- insolvency proceedings must have been initiated by or against the securities intermediary;

- the securities intermediary must not be able to satisfy the securities entitlements of all of its entitlement holders to the financial asset; and

- the securities intermediary, by transferring the financial asset (or interest therein) to the purchaser, must have violated its obligations under Section 8-504 to maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset.

Sections 8-502 and 8-510 contain more general adverse claim cut-off rules. Section 8-502 provides that once a person has acquired a security entitlement for value and without notice of the adverse claim, the adverse claim cannot be asserted against that person's security entitlement. (See Part II supra for discussion of the term "adverse claim.")) Moreover, Section 8-502 makes clear for the indirect system that it is not enough for the adverse claimant to assert that the person acquiring the security entitlement knows of any adverse claim, the person must have notice of the specific claim being made. n20

n20 This is not the case under Section 8-303, the rule regarding protected purchasers in the direct holding system. A purchaser is not a protected purchaser if it has notice of any adverse claim to the security.

Section 8-510(a) specifies a similar rule with respect to the rights of persons who purchase interests in security entitlements from entitlement holders (i.e., persons whose rights are derivative from the rights of another person who continues to be the entitlement holder).

While Sections 8-502 and 8-510 may seem to overlap with Section 8-503, the official commentary following Section 8-503 makes clear that Section 8-503 takes precedence over the more general adverse claim cut-off rules. Accordingly, the issue of whether an entitlement holder's property interest can be asserted as an adverse claim against a transferee from the securities intermediary is covered by the collusion standard and not by the lower "notice" standard.

Thus, there is no concept of owning or having an interest in a particular security, or even a particular fungible bulk of securities, which can be traced and recaptured from all but a limited class of "bona fide purchasers" - as was the case under former Article 8. As a policy matter, with certain limited exceptions noted above, finality and certainty have been given more weight. These provisions represent a change in the statute's words more than a change in practice, since the usefulness of any legal right to recapture an interest in securities depends upon the ability to trace the securities in
the first place, an unlikely proposition in the context of indirect holding patterns and large volume trading.

Another category of relationships, that of the relative rights of entitlement holders and creditors of the intermediary, is also addressed.

- Section 8-511 provides that, in the event an intermediary's assets are insufficient, entitlement holders other than creditors (sometimes loosely referred to as "customers") have priority over the claim of the creditor having a security interest in the subject financial assets.

- Section 8-511 proceeds to state, however, that if the creditor has "control" over the financial asset, the creditor will have priority. For clearing corporations, which are typically in a "direct" relationship with an issuer, making the obtaining of "control" by a secured party impractical, the rule is that the creditor always has priority over entitlement holders. n21

- In an effort to resolve disputes arising out of conflicting claims arising out of repurchase transactions, Section 8-510 provides that, where not covered by the priority rules in Article 9, a purchaser of a security entitlement who obtains control has priority over a purchaser who does not have control. Multiple purchasers who have control rank in temporal order.

- Consistent with Article 9's "upper tier priority" rule, under Section 8-511(d), the securities intermediary (through which the financial assets are held) as purchaser has priority over a conflicting purchaser having control. n21 This was considered acceptable as a policy matter in light of the highly regulated nature of clearing corporations.

What constitutes "control" depends upon the way in which the subject asset is held at the time in question, as described in Part II above. The concept of control plays a key role in both Article 8, in terms of establishing the rights and priorities among players and participants in both the direct and the indirect holding systems, and Article 9, in terms of what steps will suffice to perfect a security interest and what priority that interest will have. The role played by control in the context of competing secured parties is described below.

Significantly, control by a purchaser does not require that the original entitlement holder be divested of all access to the assets. Section 8-106(f) provides that:

A purchaser who has satisfied [the relevant control requirements] has control even if... the entitlement holder... retains the right to make substitutions for the... security entitlement, to originate... entitlement orders to the... securities intermediary, or otherwise to deal with the... security entitlement.
C. Intermediary Duties.

The duties imposed by the UCC relate to the manner in which the intermediaries must deal with the assets to which their entitlement holders have entitlements. *These provisions have no prior statutory counterpart in the UCC.*

- Section 8-504(a) establishes the duty to maintain sufficient financial assets to cover all entitlements created. Section 8-504(b) provides that, except as otherwise agreed by the entitlement holder, the securities intermediary may not grant a security interest in a financial asset it is obligated to maintain pursuant to Section 8-504(a) (compare Section 9-207);

- Section 8-505 establishes the duty to obtain payments or distributions made by the issuer of a financial asset and pass them through to the entitlement holder;

- Section 8-506 establishes the duty to exercise rights, including voting rights, with respect to a financial asset as directed by the entitlement holder;

- Section 8-507 establishes the duty to comply with orders given by entitlement holders with respect to financial assets; and

- Section 8-508 establishes the duty to change the entitlement holder's position into another available form of holding the financial asset, e.g. obtain and deliver a certificate.

Each duty is satisfied by a securities intermediary if it exercises due care in accordance with reasonable commercial standards. These duties are, to a certain extent, subject to the terms of the agreement between the intermediary and the entitlement holder. Each of the relevant statutory sections further provides that the duties are satisfied if "the securities intermediary acts as agreed upon by the entitlement holder and the securities intermediary." These agreements are subject to the implied obligation of good faith, which for Article 8 purposes is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Section 8-102(10).

There are, of course, other statutory and regulatory duties imposed on securities intermediaries (e.g., broker-dealer regulation under the Securities Exchange Act of 1934) and the UCC includes a provision designed to avoid conflict with these duties. Section 8-509 provides:

If the substance of a duty imposed upon a securities intermediary by Section 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty.

D. Special Recognition for Clearing Corporation Rules.

Pursuant to Section 8-111 of the UCC, "[a] rule adopted by a clearing corporation governing rights and obligations among the clearing corporation and its participants in
the clearing corporation is effective even if the rule conflicts with . . . [Article 8] and affects another party who does not consent to the rule." Under both the UCC and the TRADES Regulations referred to in footnote 5 above, a Federal Reserve Bank is considered a clearing corporation. The TRADES Regulations also specify that a Federal Reserve Bank Operating Circular is to be treated as a rule adopted by a clearing corporation. See TRADES Regulations, Section 357.12(c)(2).

V. Choice of Law Rules for the Direct and Indirect Systems

A. Direct Holding System.

The local law of the issuer's jurisdiction governs the validity of a security, the effectiveness of registration of transfer and the issuer's rights and duties with respect to registration of transfer. See Section 110(a)(1), (2) and (3).

Section 8-110(a)(4) and (5), however, clarify that the issuer's jurisdiction also governs whether the issuer owes any duties to an adverse claimant to a security and whether an adverse claim can be asserted against anyone to whom transfer of a certificated or uncertificated security is registered or who obtains control over the uncertificated security. Moreover, Section 8-110(c) provides that the local law of the jurisdiction in which a security certificate is located at the time of delivery governs whether an adverse claim can be asserted against a person to whom the security certificate is delivered.

The inclusion of Sections 8-110(a)(4) and (5) and 8-110(c) represent a change from former law that left the decision on the law applicable to such issues to the UCC's basic "reasonable relation" test or other common law or statutory rules of the various states.

B. Indirect Holding System.

Section 8-110 provides that the "local law of the securities intermediary's jurisdiction" governs the matter of when a security entitlement is acquired, the rights and duties of the intermediary to the entitlement holder and the treatment of adverse claims to the security entitlement. This is a change from former law that left the law governing these relationships to the UCC's basic "reasonable relation" test or other common law or statutory rules of the various states.

Section 8-110(e) sets forth a series of rules for determining the "securities intermediary's jurisdiction":

- If an agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that a particular jurisdiction is the securities intermediary's jurisdiction for purposes of this part, this article or this [Act], that jurisdiction is the securities intermediary's jurisdiction.

- If the above does not apply, and an agreement between the securities intermediary and its entitlement holder governing the securities account ex-
pressly provides that it is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

- If neither of the foregoing applies and agreement between the securities intermediary and its entitlement holder expressly states that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

- If none of the foregoing apply, the securities intermediary's jurisdiction is the jurisdiction in which is located the office identified in an account statement as the office serving the entitlement holder's account.

- If none of the foregoing apply, the securities intermediary's jurisdiction is the jurisdiction in which is located the securities intermediary's chief executive office. n22

n22 This "last stop" in the choice of law cascade was not amended to track Article 9's new rules for determining a debtor's location, which treats "registered organizations" differently -- by referring to jurisdiction of organization rather than chief executive office. See Section 9-307 (discussed below).

Section 8-110(f) provides explicitly that the securities intermediary's jurisdiction is not determined by the location of certificates or the jurisdiction of organization of the issuer (or, for good measure, the location of any data processing or other record keeping activities).

VI. Miscellaneous

Summarized below are several other significant aspects of Article 8.

A. Liability of Securities Intermediaries.

The circumstances under which a securities intermediary that has transferred a financial asset is liable to a person having an adverse claim to the financial asset are limited. The securities intermediary must have taken the action after being served with an injunction, restraining order or other legal process enjoining it from taking the action and had a reasonable opportunity to act in accordance therewith or acted in collusion with the wrongdoer in violating the rights of the adverse claimant. Where a security certificate that has been stolen is involved, the securities intermediary’s acting with notice of the adverse claim would be sufficient for liability. See Section 8-115.

n23 The same rule also applies in the case of the direct holding system, to a broker, agent or bailee that is dealing with a financial asset at the direction of its customer or principal. See Section 8-115.
The standards in Section 8-115 follow from the premise that it is essential to the securities settlement system that brokers and securities intermediaries be able to act promptly on the directions of their customers. Thus, even though a firm may have notice that someone has asserted a claim to a customer's securities or security entitlements, the firm should not have to make a legal judgment about the validity of the claim at the risk of liability either to its customer or to the third party for guessing wrong. On the other hand, the intermediary or broker should not be shielded in egregious cases where the action rises to the level of "affirmative misconduct in assisting the customer in the commission of a wrong." Official Comment 5, Section 8-115.

B. Repeal of the Statute of Frauds.

Under Section 8-113, a contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making. (The former version of Article 8 contained a special statute of frauds provision for securities contracts, which was deleted.) It was felt that the cost of litigating statute of frauds issues was not warranted by the limited protections the statute of frauds offered against fraudulent claims relating to securities contracts.

C. Warranties.

The warranties for transfers in the direct system are set out in Section 8-108. With respect to transferors, these warranties include, inter alia, that a certificate is genuine and has not been materially altered, that the transferor or indorser does not know of any fact that might impair the validity of the security and that the transfer is otherwise effective and rightful.

In addition, Section 8-108 makes clear that warranties made by an indorser are for the benefit not only of its immediate transferee but of subsequent purchasers. Further, Section 8-108 contains new warranties from parties transferring certificated securities or originating instructions for registration of transfer of uncertificated securities to the effect that (i) there is no adverse claim to the securities and (ii) the transfer does not violate any restriction on transfer.

A broker that delivers a security certificate to a customer, or causes the customer to be registered as the owner of an uncertificated security, makes the same warranties as specified above.

With respect to the separate rules for warranties in the indirect system set out in Section 8-109, a person who originates an entitlement order to a securities intermediary warrants as to its authority to give the entitlement order and as to the absence of adverse claims.

Section 8-109 also specifies the warranties given when a person who holds securities directly seeks to have the holding converted into indirect form by delivering the security, or originating, in the case of an uncertificated security, an instruction directing that the uncertificated security be credited, to a securities account. Such a person makes the transfer warranties under Section 8-108, as described above.
In turn, if a securities intermediary delivers a security certificate, or causes, in the case of an uncertificated security, the security to be registered in the name of the entitlement holder, the securities intermediary also makes the transfer warranties under Section 8-108. Thus, securities intermediaries make the same warranties as those that brokers make with respect to securities that they sell to and buy on a customer's behalf. Official Comment, Section 8-109.

The warranty provisions in Sections 8-108 and 8-109 may be adjusted by agreement. See Section 1-102(3).


Section 8-112, describing a creditor's right of legal process, is a marked improvement over the former rules regarding access to assets held by intermediaries or held by secured parties through the indirect system. Section 8-112 provides that:

- The interest of the debtor in a security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's security entitlement is maintained; and

- The interest of a debtor in a security entitlement maintained in the name of a secured party may be reached by a creditor by legal process upon the secured party.

The rules for attaching the interest of a debtor in a certificated or uncertificated security, also set out in Sections 8-112, were not problematic and remain unchanged from prior law. (The foregoing rules do not specify where or how such an attachment can be effected. Article 8's choice of law rule based on the securities intermediary's jurisdiction does not apply, and Article 9's rules for determining a debtor's location are obviously inapposite.)

VII. Article 9's Coverage of Investment Property

Article 9 of the Uniform Commercial Code, first adopted by the ALI and NCCUSL in the 1960's, governs security interests in personal property. A complete revision was most recently completed in 2001 and has been adopted in a highly uniform fashion in all fifty States and the District of Columbia. As noted above, all adopting jurisdictions enacted the uniform version of Article 9 insofar as its treatment of investment property is concerned. n24 In Article 9 terms a "debtor" is a person who creates a security interest in collateral and a "secured party" is the person in whose favor a security interest is created. n25

n24 New York enacted special rules dealing with shares in cooperative apartments, but such non-uniform provisions are not relevant for purposes of this memorandum.

n25 Article 9 also covers certain sale transactions not relevant for purposes of this memorandum.
A. Coverage.

Article 9’s scope covers "investment property," defined to include not only Article 8 securities and security entitlements, but also commodity contracts and commodity accounts. In addition to covering assets that are treated by the market like securities (i.e., credited to securities accounts) but that might not otherwise fall within Article 9's reach, such as certain insurance products, special provisions exist for commodity contracts and commodity accounts in order to clarify how security interests in these important products are created and perfected. n26

n26 The discussion of investment property in this memorandum will generally focus only on securities, securities accounts and security entitlements, and not on commodity contracts and commodity accounts.

B. Creation and Perfection of Security Interests.

Unlike the approach in some other jurisdictions, the UCC separates the concepts of "creation" (or "attachment") of a security interest, which generally means the security interest is effective as against the debtor and "perfection" of a security interest, which generally means the security interest is effective as against third parties. A security interest in securities can be created pursuant to Section 9-203 in the same fashion as a security interest in any other form of property, that is, by agreement between the debtor having rights in the collateral and the secured party giving value. If this agreement is in the form of an authenticated record (e.g., a written security agreement), there is no requirement of a "transfer," "delivery" or similar action to create the security interest. The agreement must describe the collateral, and Section 9-108 provides rules regarding the sufficiency of such descriptions. n27 Article 9 clarifies that effective security interests can be created over securities accounts as a whole, thus eliminating concern about any need to describe their contents with particularity. n28

n27 In general any description is sufficient, whether or not it is specific, if it "reasonably identifies" the collateral. Use of UCC categories are typically sufficient (with a limited exception in the case of investment property for consumer transactions). "Supergeneric" descriptions are not sufficient for security agreements, although they are acceptable for use in financing statements. See UCC 9-203 and 9-504.

n28 See UCC 9-203(h). A security interest in a securities account would also include all of the other rights of the debtor against the securities intermediary arising out of the securities account. For instance, credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement, would be covered by the security interest.

Although it is possible to create a security interest in investment property without a writing or other authenticated record if the collateral is in the secured party's pos-
session or under its control (discussed below), n29 documentation of the security arrangement is standard practice and advisable for many reasons.

n29 See UCC 9-203(b)(3)(B), (C) and (D).

Article 9 has a variety of rules for perfecting security interests in investment property depending in part upon the type of asset and the way it is held and in part upon the identity of the debtor. Of perhaps greatest significance for most market participants is the concept of "control" over investment property. This is defined in the case of securities and security entitlements simply by cross reference to Section 8-106 of Article 8, described above.

- Perfection by control is available for all types of pledgors and all types of investment property. As noted above, the concept of control has been designed to accommodate a variety of arrangements, including those that do not deny a pledgor's or another secured party's access to the asset. See Sections 9-106 and 9-314. (See Diagrams 2 through 7)

- Lenders can perfect a security interest in investment property by filing a "financing statement," a method also permitted under the UCC with respect to a variety of collateral, tangible (such as inventory) and intangible (such as receivables). See Section 9-312(a).

- "Automatic" perfection without control is provided for security interests created by brokers and securities intermediaries. See Section 9-309(10).

- A security interest in a financial asset automatically arises and is perfected in favor of a securities intermediary through which a buyer acquires the asset and to which the buyer is required to pay the purchase price, securing the buyer's obligation to make payment. See Section 9-206.

- Perfection of a security interest in a certificated security in registered form can also be accomplished by simple possession on the part of the secured party or a third person acknowledging that its possession is for the secures party's benefit. See Section 9-313(a) and (c). n30

- A 20-day temporary perfection period is provided (x) for a security interest in certificated securities perfected without filing or the taking of possession where the security interest arises for new value under an authenticated security agreement and (y) where the secured party delivers the security certificate to the debtor for the purpose of sale or exchange or for presentation, collection, enforcement, renewal or registration of transfer. See Sections 9-312(e) and 9-312(g).

- As a general rule, a security interest continues in proceeds of collateral. See Section 9-322. Any payments or distributions made with respect to investment property collateral are proceeds. See Section 9-102(a)(64). If the
proceeds of investment property collateral are identifiable cash proceeds, they remain continuously perfected without further action. In other cases, the security interest in proceeds remains perfected for 21 days, whereupon the security interest becomes unperfected unless appropriate steps have been taken to continue perfection. See Section 9-315.

n30 Section 9-313(f) specifies that a third party in possession of collateral is not required to acknowledge that it holds possession for a secured party's benefit. Section 9-313(g) provides that such an acknowledgment, once obtained by a secured party, is effective even if it violates the debtor's rights.

C. Priority.

Section 9-328 of the UCC sets forth specific rules for determining priority of security interests in investment property.

- The basic rule is that "control" means priority: the security interest of a secured party who has control has priority over a security interest of a secured party who does not. See Section 9-328(1).

- With certain exceptions, conflicting security interests of more than one secured party having control rank in temporal order. See Section 9-328(2). For example, more than one secured party could obtain control over a security certificate held by an agent for multiple lenders or over a security entitlement by way of an agreement with the relevant intermediary. This would of course require the cooperation of the agent or intermediary, which may be unobtainable for a variety of reasons, including because the agent or intermediary is prohibited from acting for subsequent secured parties in its agreement with the first.

- One significant exception to this temporal rule is that - unless otherwise agreed by the securities intermediary - a security interest in favor of the debtor's own intermediary (status that itself constitutes having control, as noted above) has priority over another secured party with control. See Section 9-328(3). One could argue that this special priority is not necessary, since in order to obtain control the non-intermediary secured party needed to obtain agreement of the intermediary in the first place, but this special rule makes a policy decision in favor of the intermediary, which has no obligation to inform the outside lender of its own security interest and whose security interest may in fact arise subsequently. (As noted above, Section 9-206 provides that a security interest arises by operation of law in favor of a securities intermediary who extends credit in connection with the acquisition of a financial asset on behalf of a buyer when that financial asset is credited to the buyer's securities account prior to payment.)
- Conflicting security interests granted by a broker or securities intermediary perfected without control (i.e., under the "automatic" perfection rule) rank equally. See Section 9-328(6).

- A security interest in favor of a secured party who is in possession of a security certificate in registered form but does not have control has priority over a conflicting security interest perfected by means other than control (i.e., simple possession beats filing or "automatic" perfection). See Section 9-328(5).

- In other cases, the basic Article 9 "first in time" rules apply. See Section 9-322(a).

- Special priority rules for proceeds of investment property are included in Section 9-328 (generally allowing the special priority afforded security interests in investment property to continue in the proceeds of that collateral, subject to certain limitations).

D. Choice of Law for Perfection and Priority.

The law governing the perfection and priority of security interests in investment property depends upon the form of investment property involved and the method of perfection chosen. The basic rule is set forth in Section 9-301. n31

- For a security interest in any form of investment property by filing, the law governing perfection is the local law of the jurisdiction in which the debtor is located as determined pursuant to Section 9-307. n32 See Section 9-305(c)(1).

- For an "automatically" perfected security interest in any form of investment property created by a broker or other securities intermediary, the law governing perfection is the local law of the jurisdiction in which the debtor is located as determined pursuant to Section 9-307. See Section 9-305(c)(2).

Except for the foregoing:

- For a security interest in certificated securities, perfection and priority are governed by the local law of the jurisdiction in which the certificate is located. See Section 9-305(a)(1).

- For a security interest in uncertificated securities perfection and priority are governed by the local law of the issuer's jurisdiction as determined pursuant to Section 8-110(d). See Section 9-305(a)(3).

- For a security interest in security entitlements and securities accounts perfection and priority are governed by the local law of the securities in-
termediary's jurisdiction - as determined in accordance with Section 8-110(e). See Section 9-305(3).

n31 The law governing creation is that provided for in the security agreement, provided it satisfies otherwise applicable rules such as the "reasonable relation" test in Section 1-105. Some states do not require any particular relation test to be met.

n32 The basic rule, in the case of most debtors, requires a determination where the debtor has its place of business or, if the debtor has more than one place of business, at its chief executive office. For individuals the proper location is that of one's "principal residence." The need to make a factual investigation is eliminated in the case of debtors constituting domestic "registered organizations" (as defined in Section 9-102(a)(76)), which are considered located in the State in which they are organized. Debtors located in jurisdictions that do not have filing registries for nonpossessory security interests are deemed to be located in the District of Columbia.

It is significant to note in this regard that the foregoing rules allow the possibility for the local law of different jurisdictions to govern perfection and priority. For example, although perfection of a security interest in security entitlements and securities accounts by filing will be governed by the local law of the jurisdiction in which the debtor is located, the priority of that security interest will nevertheless be governed by the local law of the securities intermediary's jurisdiction. This split treatment has little practical significance when both jurisdictions have adopted the same version of the UCC, but can matter if there are non-uniformities in the United States and will need to be carefully analyzed in cross-border holding patterns.

E. Other Significant Features Regarding Investment Property.

1. Rights of Secured Party in Possession or Control -- "Repledge"

Pursuant to Section 9-207(c), a secured party having possession or control of collateral under, inter alia, Section 9-106 (applicable to investment property) may create a security interest in the collateral. This provision clarifies the secured party's right to "repledge" collateral without obtaining explicit permission from the debtor. The provision eliminates the confusing reference in former law to the "debtor's right to redeem", which was viewed as suggesting that the right to repledge could not have the effect of impairing the debtor's ability to retrieve the collateral. Official Comment 5 to Section 9-207 states that the debtor continues to enjoy the right of redemption under Section 9-621 without a need to refer explicitly to the right in Section 9-207. The Official Comment notes that the debtor's right to redeem as against its secured party, however, may not be enforceable against the repledgee, as a result of applicable rules that would make the repledgee immune from the debtor's claims (e.g., Section 8-303 (protected purchaser), Section 8-502 (initial acquisition of a security entitlement), Section 8-503(e) (limitations on action by entitlement holder), Section 8-510(a) (purchaser of security entitlement's freedom from assertion of adverse claims)) or the debtor's consent to the repledge.
2. Continuation of Perfection by Control and by Possession

Special rules for continued perfection of security interests in investment property are included in Sections 9-313 and 9-314. Under Section 9-313(e), a possessory security interest in a certificated security remains perfected until the debtor obtains possession of the security certificate. Section 9-313(h) describes the circumstances under which a secured party does not relinquish possession for perfection purposes even though it has delivered the collateral to a person other than the debtor. These provisions ensure that the secured party remains perfected even if it repackages, and no longer has possession of, the certificate. Section 9-314(c) provides that control continues from the time the secured party obtains control until the secured party does not have control and the debtor (x) has or acquires possession of a certificated security, (y) is or becomes the registered owner of an uncertificated security or (z) is or becomes the entitlement holder of a security entitlement. This is an exception to the general rule for security interests perfected by control, which remain perfected by control only while the secured party retains control. This special rule was designed to protect the interest of secured parties when engaging in reuse and repledge activities that are of critical importance to the securities and derivatives markets. (See Diagrams 3 and 9)

3. Freedom from Adverse Claims

The rights of protected purchasers under Article 8 and those who would take free from adverse claims in the indirect system under Article 8 are not limited by Article 9. See Section 9-331(1)(a) and (b).

4. Additional Duties of Secured Party with Control of Investment Property

Section 9-208 imposes duties on a secured party having control of investment property where the transaction in respect of which control over the investment property was conferred on the secured party has terminated (and any related commitments have expired). In such a circumstance, the secured party is obligated within 10 days of a demand from the debtor, to release the securities intermediary or commodity intermediary with which a security entitlement or commodity contract in question is maintained from any obligation that such entity may have to comply with entitlement orders or directions of the secured party. A failure to abide by this provision makes the secured party potentially liable for damages under Section 9-625(b) and a $500 penalty under Section 9-625(e).

5. Remedies of secured parties

Part VI of Article 9 provides rules governing the exercise of remedies by secured parties. In general, a secured party is entitled to the rights provided by agreement with the debtor (with certain exceptions) and can proceed to foreclose or otherwise enforce the security interest or its claim by any available judicial procedure. Pursuant to Section 9-610, a secured party may sell or otherwise dispose of any or all of the collateral, but every aspect of the disposition must be commercially reasonable. A secured party may also, without any resort to judicial proceedings, purchase at a public disposition but not at a private disposition unless the collateral is of a kind that is customarily sold on a recognized market (such as a stock exchange). Appropriate prior
notice to the debtor and certain third parties is required unless the collateral is of the foregoing type. n33

n33 If the collateral is not "of a type customarily sold on a recognized market" the highly technical search and notification rules specified in Section 9-611 will apply.

Official Comment 8 to Section 9-610 on disposition of collateral after default provides that a disposition that qualifies for a "private placement" exception under the Securities Act of 1933 could nevertheless constitute a "public" disposition under Article 9 (a circumstance that has been the subject of SEC no-action letters). Comment 8 also confirms that a secured party is not required to obtain the issuer's compliance with federal registration requirements in order to be able to satisfy the "commercially reasonable" standard for a foreclosure sale.

One remedy a secured party does not have -- and cannot enforceably obtain prior to default -- is the right to retain the collateral in full or partial satisfaction of the debt. Pursuant to Sections 9-602(j) and 9-620, this right can only be obtained with the debtor's consent as evidenced in a record authenticated after default. There is no exception to this rule for collateral "of a type customarily sold on a recognized market".

Diagram 1
 Direct Holding System
  [See Diagram 1 in original]
 Indirect Holding System

Diagram 2
 Control Via Delivery Certificated Securities
  [See Diagram 2 in original]
Perfection determined pursuant to § 9-314.
Priority and freedom from adverse claims determined pursuant to § 8-303 and § 9-328.

Diagram 3
 Control Via Delivery Uncertificated Securities
  [See Diagram 3 in original]
Perfection determined pursuant to § 9-314.
Priority and freedom from adverse claims determined pursuant to § 9-328 and § 9-331 and § 8-303.
Diagram 4
   Control Via Issuer Control Agreement
      [See Diagram 4 in original]
Perfection determined pursuant to § 9-314.
Priority determined pursuant to § 9-328.

Diagram 5
   Control Via Becoming the Entitlement Holder
      [See Diagram 5 in original]
Perfection determined pursuant to § 9-314.
Priority and freedom from adverse claims determined pursuant to § 9-328 and § 9-331 and § 8-502.

Diagram 6
   Control Via Securities Account Control Agreement
      [See Diagram 6 in original]
Perfection determined pursuant to § 9-314.
Priority determined pursuant to § 9-328.

Diagram 7
   Control Via Being the Securities Intermediary
      [See Diagram 7 in original]
Perfection determined pursuant to § 9-314.
Priority determined pursuant to § 9-328.

Diagram 8
      [See Diagram 8 in original]

Diagram 9
      [See Diagram 9 in original]

Control is obtained by Company II and continues to be maintained until Company I becomes the entitlement holder again.

UCC Sections 9-106 and 9-314.
Addendum Re: TRADES Regulations

Federal regulations govern many aspects of the issuance of, and creation and transfer of interests in securities issued by the United States Treasury States Treasury n34 (a "Treasury Book-Entry Security") and the government-sponsored entities (the "GSEs") listed below and maintained in book-entry form through the Federal Reserve Bank system.

The Federal National Mortgage Association ("FNMA")

The Federal Home Loan Mortgage Corporation ("FHLMC")

The Federal Home Loan Banks ("FHL Banks")

The Resolution Funding Corporation ("RFC")

The Federal Farm Credit Banks Funding Corporation ("FFCBFC") on behalf of the Farm Credit Banks

The Farm Credit System Financial Assistance Corporation ("FCSFAC")

The Federal Agricultural Mortgage Corporation ("FAMC")

The Student Loan Marketing Association ("SLMA")

The Tennessee Valley Authority ("TVA")

The Government National Mortgage Association ("GNMA") n35

The regulations (the "TRADES Regulations") issued by the United States Treasury (the "Treasury") parallel and, in certain cases, incorporate the revisions to Article 8 of the UCC. Subject to narrowly defined exceptions, the rights and obligations of the United States and the Federal Reserve Banks with respect to Treasury Book-Entry Securities maintained in the TRADES system are stated to be governed solely and exclusively by the TRADES Regulations, the offering circulars pursuant to which Treasury Book-Entry Securities are sold, the offering announcements and Federal Reserve Bank Operating Circulars. See Section 357.10.

n34 31 C.F.R. pt. 357.

Information regarding these regulations and the Book-Entry Regulations may be found on the website of the United States Treasury's Bureau of Public Debt (www.publicdebt.treas.gov/cc/cctrades.htm).

At the time that the TRADES Regulations were issued in August 1996, Treasury noted in the commentary (the "Commentary") thereto that it had taken steps to facilitate simultaneous adoption by U.S. government-sponsored entities of similar book-entry rules. In fact, according to the Commentary, the delay until January 1, 1997 in the effectiveness of the TRADES Regulations was intended to "permit sufficient time for rules similar to TRADES to be in place for GSEs." As a result of this process, the regulations issued by the GSEs in the first week of January 1997 were modeled after TRADES Regulations, with minimal alterations. As a result of the similarity between the TRADES Regulations and the book-entry system applicable to U.S. Treasury obligations and the regulations issued by the GSEs and their book-entry systems, the remainder of this section will concentrate on the TRADES Regulations, and it should be assumed that the regulations of the GSEs are comparable, except as noted below.

The TRADES Regulations include limited federal preemption.

Subject to narrowly defined exceptions, the rights and obligations of the United States and the Federal Reserve Banks with respect to Treasury Book-Entry Securities maintained in the TRADES system are stated to be governed solely and exclusively by the TRADES Regulations, the offering circulars pursuant to which Treasury Book-Entry Securities are sold, the offering announcements and Federal Reserve Bank Operating Circulars. See Section 357.10.

--- Creation of Security Entitlements.

A Participant's security entitlement is created as a matter of federal law when a Federal Reserve Bank indicates on its books that a Treasury Book-Entry Security has been credited to the Participant's securities account. See Section 357.12. The TRADES Regulations clarify that the meaning of a security entitlement under federal law is somewhat different than under the Revised UCC. Under the TRADES Regulations, a Participant has a direct claim against the United States for interest and principal even though, under the Revised UCC, a Participant, as an entitlement holder, would be limited to a claim against its immediate securities intermediary, a Federal Reserve Bank, for such payment. Neither the United States nor the Federal Reserve Banks, however, have any obligation to persons holding their interests in a Treasury Book-Entry Security at levels below the level of a Participant (Section 357.13); the nature of a Security Entitlement of an Entitlement Holder below the level of a Participant would be determined pursuant to applicable law (Section 357.11). The selection of such applicable law is discussed in detail below. As a result of federal preemption, however, the portion of any applicable law describing the obligations of issuers (or their agents) of securities does not apply to either the United States or Federal Reserve Banks.

When required by Federal law or regulation or pursuant to a specific agreement with a Federal Reserve Bank, a security interest in favor of the United States, a Federal Reserve Bank or other person may be created and perfected by a Federal Reserve Bank marking its books to record the security interest. Such a security interest would have priority over any other interest in a security entitlement (other than a security interest in favor of the United States that is marked on the books of a Federal Reserve Bank). Except with respect to such security interests marked directly on the books of a Federal Reserve Bank, the TRADES Regulations do not address how a security interest in a Treasury Book-Entry Security is created or what law governs the creation of a security interest. Security interests (including in favor of a Federal Reserve Bank) may also be perfected by any method available under applicable law as determined below. See Section 357.12(c).

The TRADES Regulations provide clear choice of law rules for determining the law governing rights and obligations with respect to Security Entitlements to the extent not specifically preempted by federal law.

The choice of law rules in the TRADES Regulations (Section 357.11(a)) state that, where not specifically preempted by federal law, the law (not including the conflict-of-law rules) of a securities intermediary's jurisdiction governs:

- The acquisition of a security entitlement from the securities intermediary.
- The rights and duties of the securities intermediary and entitlement holder relating to such security entitlement, including any duties owed by the securities intermediary to an adverse claimant.
- Whether adverse claims can be asserted against a person acquiring a security entitlement from a securities intermediary or an entitlement holder.
- Except with respect to automatic perfection and perfection by filing, the perfection, the effect of perfection or non-perfection and priority of a security interest in a security entitlement.

In a cascade identical to that set forth in Section 8-110(e) of the Revised UCC n36, the TRADES Regulations specify, in Section 357.11(b), rules for determining a securities intermediary's jurisdiction. n37

n36 On February 15, 2002, the Bureau issued an interim rule making certain technical and conforming changes to the TRADES Regulations in order to make them consistent with the latest revisions to Section 8-110(e) made in connection with the most recent revisions to Article 9. These changes include: (a) the addition of a new Section 357.11(b)(1) permitting a securities intermediary and its entitlement holder expressly to specify a jurisdiction exclusively for purposes of Article 8, the addition of a new Section 357.11(d) to make clear that the location of the debtor, relevant to determining whether and how a security interest may be perfected automatically or by the filing of a financing statement, is determined by state law, including Revised Article 9. The TRADES Regulations were also restated in plain language, as required by presidential Executive Order. The
Bureau stated that it would coordinate with the other Government Sponsored Enterprises and agencies having rules modeled on TRADES, "in an effort to maintain consistency among all these rules." 67 Fed. Reg. at 7079. No further regulations have been issued by the Bureau or other government sponsored enterprises, however.

n37 With respect to a security interest in a security entitlement created by a Participant in favor of a Federal Reserve Bank (such as a lien securing an overdraft in a Participant's funds account with the Federal Reserve Bank or a lien securing a discount window loan) which is not recorded on the Federal Reserve Bank's books, the TRADES Regulations provide that the lien is governed by the law (not including the conflict-of-law rules) of the jurisdiction where the head office of the Federal Reserve Bank maintaining the Participant's securities accounts is located. In the limited circumstances in which a Federal Reserve Bank may have a security interest in the Treasury Book-Entry Securities of a non-Participant and the security interest is not marked on the books of the Federal Reserve Bank, such a security interest would be governed by the law of the jurisdiction of the non-Participant's securities intermediary. See Section 357.10.

A provision to the effect that if the jurisdiction selected pursuant to these choice of law rules is a state that has not adopted the "Revised UCC" (referring to the 1994 revisions to UCC Article 8), the governing law "shall be the law of that State as though the Revised UCC had been adopted by that State" has become inoperable. See Section 357.11(d) and the Bureau's publications at 63 Fed. Reg. 69191 (December 16, 1998) and 66 Fed. Reg. 33832 (June 26, 2001).

Not all issues of perfection are governed by the law of the securities intermediary's jurisdiction. The law of the jurisdiction in which the person creating a security interest is located, regardless of whether that jurisdiction has adopted the Revised UCC, governs whether and how the security interest may be perfected automatically or by filing a financing statement. See Section 357.11(c). Uniformity in these methods of perfection was not considered essential. Priority of all security interests remains, however, governed by the law of the jurisdiction of the securities intermediary as determined above.

The TRADES Regulations clarify the procedure for serving notice of attachment in respect of Treasury Book-Entry Securities.

Section 357.44 provides that the interest of a debtor in a security entitlement may be reached by a creditor only by legal process upon either (i) the securities intermediary with whom the debtor's securities account is maintained or (ii) where the security entitlement is maintained in the name of a secured party, by legal process upon the secured party. This portion of Section 357.44 is very similar to that set forth in Section 8-112. Section 357.44 goes on to provide, however, that "these regulations do not purport to establish whether a Federal Reserve Bank is required to honor an order or other notice of attachment in any particular case or class of cases. Thus, while the possibility of service on a Federal Reserve Bank is, by virtue of the fact that a Federal
Reserve Bank is a securities intermediary, provided for, it is not a foregone conclusion that a Federal Reserve Bank would have to comply with the notice.

**Addendum Re: International Developments**

**The Hague Choice of Law Convention for Transactions involving Securities Held with Intermediaries**

On December 13, 2002, delegates of the governments of more than 50 countries reached agreement at The Hague on a final text of a Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary n38. In the movement towards book-entry systems, it has become increasingly difficult for financial market participants to determine what law that would apply to transactions involving an interest in securities held through these systems, and the Convention represents an international consensus on the choice of law applicable to transactions involving securities held in accounts with intermediaries. The Convention deals only with choice of law; it has no effect on the substantive law that will be applied once the choice of law determination has been made.


A significant accomplishment of the Convention was gaining consensus on choice of law principles for securities held with intermediaries based not upon the location of the securities (typically the traditional approach) but upon the "place of the relevant intermediary". The Convention -- known as the "Hague Securities Convention" -- thus follows the approach to choice of law for the indirect holding system reflected in Article 8 of the Uniform Commercial Code.

The primary rule of the Convention for determining the applicable law is to look to the law in force in the jurisdiction expressly agreed in the agreement between the customer and the intermediary governing the securities account, provided that support can be established for the choice of that law (in the form of an office that performs certain functions in that jurisdiction). If the applicable law is not determined in this manner, there are certain fall-back provisions in the Convention that would result, ultimately, in the applicable of the law of the jurisdiction in which the intermediary is organized. The Convention provides fairly detailed provisions as to how these determinations are to be made, including factors that are to be disregarded in the analysis.

The Convention requires that the applicable law be applied to the matters specified as within the scope of the Convention, which include the effect against intermediaries and third parties of the rights resulting from a credit of securities to securities accounts, the effect against intermediaries and third parties of transfers and pledges of
securities held with intermediaries, priorities among competing claimants to such securities, and the duties of intermediaries to adverse claimants.

The Convention also deals with a number of other important considerations. These include (i) the protection of rights on change of the applicable law; (ii) the applicability of the Convention in insolvency proceedings; (iii) the determination of applicable law for multi-unit States (nations); and (iv) certain transitional provisions for determining priorities between pre-Convention and post-Convention interests and for dealing with pre-Convention account agreements and securities accounts.

The Convention applies, i.e., determines the applicable law, whenever the law of more than one nation would apply to the matters within its scope. Once it enters into force, the Convention can become applicable to a transaction or the adjudication of competing claims at any point in time. Thus, prudence dictates that transactions should anticipate application of the Convention, whether or not the relevant parties are located in, or have selected the law of, a nation that has adopted the Convention.

The Convention is to enter into force three months after three nations have ratified it. The U. S. and Switzerland signed the Convention in July 2006 and are proceeding forward with ratification/adoptions. Many industry participants and practitioners are actively engaged in promoting U.S. ratification as soon as possible, which is expected to occur during 2007.

The New Unidroit Project on Substantive Law Rules Relating to Investment Securities Held with an Intermediary

As negotiation of The Hague Convention moved toward conclusion, the International Institute for the Unification of Private Law (UNIDROIT) launched a new project that complements the work at The Hague. The UNIDROIT project is concerned with international development of substantive law in the field of indirect holding of securities. The premise of both the Hague and UNIDROIT projects is that rapid emergence of a global capital market in securities requires a new platform of legal rules that will serve the needs of participants in that market. As noted above, the Hague Securities Convention provides choice-of-law rules that afford greater certainty as to the domestic national law that governs rights and duties of securities intermediaries, account holders, purchasers -- including lenders that take securities as collateral, and priorities among competing claimants. The UNIDROIT project is concerned with the adequacy of existing national laws on indirect holding of securities and with the compatibility of those laws when they interact.

In 2002, UNIDROIT established a small study group charged to consider the need for harmonized substantive rules for the use of securities held with intermediaries as collateral. Many of the members of this group were actively involved in the Hague Securities Convention drafting process. Various meetings were held in New York and in Europe, at which the views of market participants, among others, were solicited. The study group concluded its work and produced a draft instrument for public dissemination in November 2004. The inter-governmental stage, during which formal consideration and revision of the draft instrument occurs, began in May of 2005 (initial
meeting) and work continued during 2006 (second meeting in March 2006, third in November 2006 with ongoing intersessional work). n40 What is hoped to be the final inter-governmental meeting is scheduled for May 2007 with a diplomatic conference tentatively planned to take place in Geneva in February of 2008. n41

n39 Professor Curtis R. Reitz, Biddle Professor of Law at the University of Pennsylvania Law School, represented the United States on the Study Group and Sandra M. Rocks participated as a co-coordinator for the private financial sector.


n41 Sandra M. Rocks generally participates in these sessions as a representative of EMTA.

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This opinion is uncorrected and subject to revision before publication in the New York Reports.

USCOA2 No. 38

Paul B. Lackey, for appellant-respondent.

Katherine Ash, for respondents-appellants.

READ, J.: The United States Court of Appeals for the Second Circuit has asked us whether the eight promissory notes at issue in this case are "securities" within the meaning of section 8-102(a)(15) of the Uniform Commercial Code. For the reasons that follow, we conclude that they are.

I.

In April 1998, Norton McNaughton, Inc. (subsequently, McNaughton Apparel Group, Inc.) acquired two women's apparel companies -- Jeri-Jo Knitwear Inc. (owned by Leonard Schneider), and Jamie Scott, Inc. (owned by his three children, Leslie, Susan and Scott Schneider). These two businesses were combined to form a division of McNaughton called Jeri-Jo Knitwear, Inc. (Jeri-Jo). Under the terms of the Agreement of Purchase and Sale, McNaughton paid the Schneiders $ 55 million in cash, assumed
$10.9 million in debt, and agreed to a future earn-out payment based on Jeri-Jo's performance over the two-year period ending in June 2000, during which the Schneider children managed this business for McNaughton. n1

n1 Earn-out provisions in merger-and-acquisition agreements are intended to accommodate the seller's desire for compensation for the anticipated future value of the transferred assets and the buyer's reciprocal desire to avoid overpaying for potential, but as yet unrealized, value. In this case, the earn-out was based on Jeri-Jo's profitability, not its sales.

The earn-out payment was fixed at $190 million, which the Agreement called for McNaughton to pay to the Schneiders in cash or, at McNaughton's option, up to 50% in common stock. In light of available cash flow, however, McNaughton was only able to make the minimum cash payment, and wished to avoid the significant dilutive effect on earnings of paying the balance in stock. As an alternative, McNaughton proposed issuing the Schneiders a three-year note secured solely by the face value of the stock to which they were entitled. Ultimately, McNaughton and the Schneiders compromised, agreeing to retire the earn-out obligation as of August 29, 2000 for $161 million, consisting of $125 million in cash ($95 million to be paid immediately and $30 million to be paid on or before November 30, 2000, subject to financing); two million shares of common stock at $13 per share ($26 million); and four three-year subordinated promissory notes with a combined face value of $10 million. They also agreed that if financing could not be arranged for the $30 million cash payment, McNaughton would pay the Schneiders $59 million in a combination of cash, unsecured subordinated notes and/or shares of common stock at McNaughton's option.

In October 2000, McNaughton's chief executive officer informed the Schneiders that, given McNaughton's stock price, the company was unlikely to raise the additional equity needed to fund the $30 million payment fast coming due. He asked the Schneiders to extend the November 30th deadline to April 30, 2001. In the end, the Schneiders declined this request and, on December 10, 2000, four three-year subordinated promissory notes with an overall face value of $59 million were issued to them in lieu of the $30 million cash payment.

The eight notes with an aggregate face value of $69 million (the four issued in August 2000 plus the four issued the following December), running 12 pages apiece, were each payable to one or another of the four Schneiders. n2 The notes required McNaughton to make quarterly principal and monthly interest payments to the named payee. McNaughton was designated the maker of the notes, each of which bore the following restrictive legend:

"THIS NOTE HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. IT MAY NOT BE TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT UNDER SUCH ACT OR AN OPINION OF COUNSEL TO THE MAKER THAT SUCH REGISTRATION IS NOT REQUIRED."

Each note was marked "SUBORDINATED PROMISSORY NOTE" on its face because these notes were subordinate to McNaughton's existing bank and bond debt amount-
ing to roughly $350 million. Upon McNaughton's default, the payee had the right to declare the entire amount under the note due and owing, and to elect either to receive payment in stock or to accelerate payment. The notes stated that they were "governed by and construed in accordance with" New York law.

n2 Specifically, the subordinated promissory notes issued and dated August 29, 2000 were payable to Leonard Schneider in the amount of $4 million; Leslie Schneider in the amount of $2.4 million; Scott Schneider in the amount of $1.2 million; and Susan Schneider in the amount of $2.4 million. The subordinated promissory notes issued December 10, 2000 and dated December 1, 2000 were payable to Leonard Schneider in the amount of $23.6 million; Leslie Schneider in the amount of $14.16 million; Scott Schneider in the amount of $7.08 million; and Susan Schneider in the amount of $14.16 million.

The securities industry professionals who subsequently dealt with the notes considered them to be high-risk debt akin to junk bonds. Consequently, it was anticipated that any potential purchaser would expect a high yield or internal rate of return. Concomitantly, the notes carried a substantial, variable interest rate (initially, 9.34% on the December notes).

As it turned out, McNaughton was acquired in June 2001 by Jones Apparel Group, Inc. As a result of the merger (an "Event of Default" under the terms of the notes), Jones redeemed the notes at par value, paying the Schneiders $69 million plus interest through June 19, 2001. The parties to this litigation dispute whether the Schneiders reneged on an oral agreement to sell seven of the eight notes when they learned of the planned acquisition before it was announced to the public. In particular, Highland Capital Management LP alleges that the Schneiders, through their agent and broker, Glen Rauch of Glen Rauch Securities, Inc., retained RBC Dominion Securities Corporation (now RBC Capital Markets Corporation) to market the notes on their behalf, and that on March 14, 2001, RBC purchased the notes from the Schneiders for 51 cents on the dollar, and then immediately resold seven of the eight notes to Highland for 52.5 cents on the dollar. n3

n3 Highland alleges that RBC resold the remaining note to Fidelity Management and Research Company, also on March 14, 2001 and for 52.5 cents on the dollar.

On October 18, 2001, Highland brought this suit against the Schneiders in Texas state court. The action was removed to federal court in Texas on diversity grounds, and then transferred to the United States District Court for the Southern District of New York. As relevant here, the complaint alleges that the Schneiders breached an oral agreement to sell the notes to Highland or, alternatively, breached a binding preliminary agreement to do so, or breached an agreement to sell the notes to RBC, of which Highland was a third-party beneficiary. n4 The Schneiders answered, denying they had ever agreed to sell the notes to anyone on March 14, 2001 at any price, and asserting that any such oral agreement would have been unenforceable anyway since it fell within the statute of frauds. After the close of discovery, the Schneiders moved for summary judgment to dismiss the complaint.
n4 RBC intended to act as a "riskless principal." That is, RBC sought to eliminate its risk for variable market conditions by obtaining commitments to a specified price from both the seller (here, 51 cents on the dollar) and the ultimate buyer (here, 52.5 cents on the dollar from two buyers) before executing a trade with the seller. RBC's compensation on the transaction would have been the spread between these two prices.

The Uniform Commercial Code generally bars enforcement of purported agreements to sell personal property in excess of $5,000 unless "there is some writing which indicates that a contract for sale has been made between the parties at a defined or stated price, reasonably identifies the subject matter, and is signed by the party against whom enforcement is sought or by his authorized agent" (UCC 1-206[1]). In considering the Schneiders' statute-of-frauds defense, the District Judge observed that the statute does not apply to a contract for the sale or purchase of a "security" (UCC 8-113) (Highland Capital Mgt. LP v Schneider, 2005 WL 1765711, *13, 2005 US Dist LEXIS 14912, *42 [SD NY, July 26, 2005] citing The Wharf (Holdings) Ltd. v United Intl. Holdings, Inc., 532 U.S. 588, 595 [2001] ["Oral contracts for the sale of securities are sufficiently common that the Uniform Commercial Code and statutes of frauds in every State now consider them enforceable"]). He concluded, however, that the seven promissory notes were not securities for purposes of article 8 of the Uniform Commercial Code, because they were not transferrable within the meaning of section 8-102(a)(15)(i).

The District Judge dismissed Highland's two breach-of-contract claims against the Schneiders on the merits. Although he found an issue of material fact with respect to Highland's claim to be a third-party beneficiary of a contract between the Schneiders and RBC, the District Judge dismissed this cause of action for lack of subject matter jurisdiction. He reasoned that since the underlying oral agreement, even if proven, would only be enforceable up to $5,000 because of the statute of frauds, the claim fell short of the $75,000 statutory threshold for diversity jurisdiction. Highland appealed.

"Given the dearth of caselaw on what constitutes a security under the New York version of [article 8] of the New York U.C.C., and the manifest significance of the determination," the Second Circuit retained jurisdiction over Highland's three contract-based claims, and certified the following question to us: "Based on this record, do the eight promissory notes issued by McNaughton Apparel Group, Inc., to the Schneiders fall within the definition of a security as contemplated by section 8-102(a)(15) of the New York Uniform Commercial Code?" (Highland Capital Mgt. LP v Schneider, 460 F3d 308, 322 [2d Cir 2006] [quotation marks omitted]). We answer that question in the affirmative.

II.

The Uniform Commercial Code defines "security" at section 8-102(a)(15) as

"an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:
"(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;

"(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and

"(iii) which:

"(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or

"(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article."

Thus, the promissory notes must fulfill the requirements of subparagraphs (i) (the transferability test), (ii) (the divisibility test) and (iii) (the functional test) of section 8-102(a)(15) in order to qualify as a security for purposes of article 8 (see generally UCC 8-102, Comment 15; Hawkland & Rogers, UCC Series § 8-102:01 [Rev Art 8]; see also, NY Bill Jacket, 1997 A.B. 6619, ch 566 at 68 [Report on Proposed Revisions to Article 8 to the Association of the Bar of the City of New York prepared by The Committee on Uniform State Laws and The Banking Law Committee of the Association] ["'Security' as defined in Revised Section 8-102[a][15] . . . includes . . . any other obligation of the issuer . . . that is transferable, divisible, and is dealt in or traded on securities exchanges"]).

First, we must consider whether the notes are obligations "represented by a security certificate in bearer or registered form." Section 8-102(a)(4) defines a "[c]ertificated security" as "a security that is represented by a certificate," and section 8-102(a)(16) defines a "security certificate" as "a certificate representing a security." These definitions are, as the Second Circuit observed, somewhat circular, and might refer either to a specialized document like a traditional stock certificate or, more generally, to a paper embodying the underlying intangible interest. Of course, the definitions in section 8-102 were deliberately worded by the drafters "in general terms, because they must be sufficiently comprehensive and flexible to cover the wide variety of investment products that now exist or may develop" (UCC 8-103, Comment 1 [emphasis added]). We see no reason to accept the Schneiders' invitation to read "certificated security" and "security certificate" more narrowly than their plain words suggest. Thus, we interpret these terms to encompass the eight subordinated promissory notes, which are papers that definitively embody and evidence the underlying intangible obligation of McNaughton to the Schneiders.

The notes are obviously not in bearer form; therefore, our next inquiry is whether they are in "registered form." In this regard, section 8-102(13) states that
"[r]egistered form,' as applied to a certificated security, means a form in which:

"(i) the security certificate specifies a person entitled to the security; and

"(ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states."

Each of the notes specifies one of the four Schneiders as the "person entitled to the security," which satisfies section 8-102(13)(i). Accordingly, we must next look at whether "a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer," as required by section 8-102(13)(ii) (emphasis added). The Schneiders (and the dissent) argue that in order to fulfill this requirement, McNaughton must have set up or kept separate and independent transfer books for this purpose at the time it issued the notes. We agree with the Second Circuit, however, "that the proper inquiry is whether the notes could have been registered on transfer books maintained by McNaughton, not whether they were registered on transfer books at the time of the litigation" (460 F3d at 314 [emphasis in original] [discussing identical language in section 8-102(15)[i]].

In this regard, the rules in part 4 of article 8 are instructive. Part 4, along with parts 2 and 3, deals with the rights of persons who hold certificates directly, as the Schneiders did here. Section 8-401 sets out the preconditions that trigger the issuer's duty to register a certificated security when it is presented with a request to register a transfer. n5 Thus, the phrase "may be registered" in section 8-102(13)(ii) refers to whether McNaughton would have been required to register the transfer of the notes to a third-party at the Schneiders' request.

n5 These preconditions for certificated securities include whether, under the security's terms, the person seeking registration of transfer is eligible to have the security registered in his name; the indorsement is made by the appropriate person or an agent with actual authority; reasonable assurance is given that the indorsement is genuine and authorized; applicable tax laws have been complied with; the transfer does not violate any restriction on transfer imposed by the issuer against a person with actual knowledge, or constructive knowledge (i.e., any restriction is conspicuously noted on the certificate); there is not in force an effective demand by a registered owner that the issuer not register a transfer; and the transfer is in fact rightful or is to a protected purchaser (see UCC 8-401).

We conclude that McNaughton ultimately would have been constrained to do so. McNaughton did not restrict transfer of the notes other than by the legend, as its chief executive officer acknowledged. And the restrictive legend itself suggests that the parties contemplated the possibility of future transfer. As Highland points out, as a practical matter, McNaughton would have had to have recorded any transfer of the notes in order to protect itself and the senior debt holders. For example, in the event of default,
the payee of the notes could have elected conversion of the principal to common
stock, thus diluting other shareholders' value; and because the notes called for hefty
payments of principal and interest, McNaughton had to have a way to keep track of
the proper payees. Accordingly, we conclude that the notes satisfy the transferability
test in UCC 8-102(a)(15)(i): they were obligations represented by a security certifi-
cate in registered form. n6

n6 We note that we are not "[c]onfusing registrability upon transfer books
with recording in corporate books generally," as the dissent contends (dissenting
op at 7). Rather, we conclude, for the reasons stated, that "the notes could have
been registered on transfer books maintained by McNaughton" (460 F3d at 314
[emphasis in original]). The dissent also acknowledges that McNaughton had (or
must have had) transfer books (presumably, to register transfer of the 12 1/2%
senior notes), but asserts that "those books were not available for registering
transfers of the notes at issue here" (dissenting op at 5). Even if correct, this
pronouncement begs the question of whether, in light of section 8-104,
McNaughton would have been required to register transfer of the subordinated
promissory notes if the Schneiders had asked McNaughton to do so.

Further, the notes satisfy the divisibility test in section 8-102(a)(15)(iii).
"[M]inimum compliance with this formality requires that there be at least two instru-
ments in a specified class or series, or that the single instrument be divisible into at
least one additional instrument" (Allegaert Chem. Bank, 657 F2d 495, 507 [2d Cir
1980] [citation and quotation marks omitted]); see also Baker v Gotz, 387 F Supp
1381, 1390 [D Del 1975] [where six notes are issued for a total of 25,360,000 Swiss
francs, the notes are "patently one of a class or series"] [citation and quotation marks
omitted]; UCC 8-102, Comment 15 ["The divisibility test of subparagraph (ii) applies
to the security -- that is, the underlying intangible interest"]). Here, there were eight
notes, divided into two groups of four notes each. The eight notes were identified in
McNaughton's Form 8-K as a class of obligations, in the same category, in fact, as
McNaughton's 12 1/2% senior notes, which the Schneiders concede were article 8 se-
curities.

Next, the notes fulfill the functional test in section 8-102(a)(15)(iii)(A) because
these obligations "[were], or [were] of the type, dealt in or traded on securities ex-
changes or securities markets." This component "provides flexibility while ensuring
that the Article 8 rules do not apply to interests or obligations in circumstances so un-
connected with the securities markets that parties are unlikely to have thought of the
possibility that Article 8 might apply" (UCC 8-102, Comment 15). Tellingly, the many
securities industry professionals from Rauch, RBC and Highland who dealt with the
notes uniformly treated them as securities. McNaughton's chief executive officer,
when he first proposed issuing the notes in lieu of cash or stock, described them as a
"form of convertible subordinated debenture." When McNaughton issued the notes to
the Schneiders in August 2000, it reported its actions to the Securities and Exchange
Commission, and put out a press release to inform the public.

Finally, our determination that these subordinated promissory notes are article 8
securities is consistent with existing caselaw, sparse though it may be (see e.g. Vigi-
lant Ins. Co. of Am. v Hous. Auth. of El Paso, 87 NY2d 36, 43 [1995] [stating broadly
that "article 8 of the Uniform Commercial Code . . . governs stocks, bonds and other
evidences of indebtedness"]; see also Baker, supra [promissory notes are securities
under section 8-102]; S.N. Phelps & Co. v Prudential Ins. Co. of America, US Dist Ct,
Conn, Nov. 22, 1991, Cabranes, J. [considering senior subordinate notes, essentially
indistinguishable from the subordinated promissory notes in this case, to be article 8
securities]). Treating these notes as article 8 securities comports
with a central goal of
the Uniform Commercial Code, which is to create a framework for commercial activity
that reflects and fosters developing custom and usage. Or as one commentator re-
marked with specific reference to article 8: "[T]he definition [of securities] will change
as 'securities' trading practices evolve to include or exclude new property interests. It
is believed that the definition will cover anything which securities markets, including
not only the organized markets but as well the 'over-the-counter' markets, are likely
to regard as suitable for trading" (8 Lawrence, Lawrence's Anderson on the Uniform
Commercial Code § 8-102:1, at 29 [3d ed rev 2005]; see also Bentley v ASM Com-
munications. Inc., 1991 WL 105220, at *2, 2005 US Dist LEXIS 7855, at *5-6 [SD NY,
June 11, 1991] [citing pre-1997 Comment 2 to section 8-102 to support defining the
term "security" broadly]).

Accordingly, the certified question should be answered in the affirmative.

Highland Capital Management LP v Leonard Schneider, Leslie Schneider, Scott Schnei-
der and Susan Schneider and Jenkens & Gilchrist Parker Chapin, LLP and RBC Domi-

tion Securities Corp.

No. 38

SMITH, J. (dissenting):

The question of when a promissory note is a "security" is a familiar one in federal
securities law, and has proved very difficult (see e.g. Reves v Ernst & Young, 494 U.S.
56 [1990]; Chemical Bank v Arthur Andersen & Co., 726 F2d 930 [2d Cir 1984]; Ex-
change Nat. Bank of Chicago v Touche Ross & Co., 544 F2d 1126 [2d Cir 1976]). The
authors of the Uniform Commercial Code made the question of what is a "security" for
UCC purposes easier, by including in the definition of "security" an element not pre-

tant in federal securities law: with some exceptions, an obligation is not a security for
UCC purposes unless it "may be registered upon books maintained for that purpose by
or on behalf of the issuer." Today, the majority effectively undoes the work of the
UCC's authors, by reading this registrability requirement in so broad a way as to make
it meaningless.

Though it is not apparent from the majority opinion, registrability is the only sig-
nificant issue in this case. No one disputes that what the majority calls the "divisibility
test" and the "functional test" in the UCC definition of "security" (UCC 8-102 [a] [15]
[iii] and [iii]) are met here. The majority holds that the notes at issue are "represented
by securities certificates" within the meaning of UCC 8-102 (a) (15) (i), but it does not
matter whether the majority is right or wrong about this, because registrability is ne-
essary to make either an uncertificated obligation or a non-bearer certificated obliga-
tion into a security. If the obligation is certificated, the certificate must be in either
"bearer or registered form," and the definition of "registered form" requires that "a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states" (UCC 8-102 [a] [13][ii]). If the obligation is not certificated, it is still a security if it meets the other tests and its "transfer . . . may be registered upon books maintained for that purpose by or on behalf of the issuer" (UCC 8-102 [a] [15][i]). Registrability is therefore critical, whether there is a certificate or not.

Before considering the meaning of the registrability requirement, it is useful to consider why the UCC's authors made it part of their definition of "security" -- a definition that is completely independent of the federal securities law definition of the same term (see UCC 8-102, Comment 3 [1977 Amendments] reprinted in, 8 Lawrence's Anderson on the UCC § 8:102:1, at 29-30 [3d ed rev 2001]). The apparent reason for the requirement is to facilitate line-drawing -- to provide a relatively simple test to distinguish between obligations and interests that are securities and those that are not. As the Official Comment says: "The definition of registered form . . . serves primarily to distinguish Article 8 from instruments governed by other law, such as Article 3" (UCC 8-102, Comment 13).

These distinctions matter. For example, the rights and obligations of an issuer and holder of an Article 3 negotiable instrument are substantially different from those of an issuer and holder of an Article 8 security. The issuer of a security in registered form may treat the registered owner as the owner for all purposes, until the security is presented for registration of transfer (see UCC 8-207 [a]). The issuer of an unregistered negotiable instrument does not have that option. The indorser of a negotiable instrument may also be liable to subsequent holders in the event that the issuer defaults (see UCC 3-413). The indorser of an article 8 security, in contrast, makes no warranties with respect to the issuer's ability to satisfy the underlying obligation (see UCC 8-108).

The need for clear distinctions led the authors of the UCC to adopt the formalistic requirement of registrability. Such formalism would be out of place in the federal securities laws, which have the prevention of fraud and other abuses in securities markets among their primary purposes. Congress wanted to make evasion of the federal securities laws difficult, and accordingly:

"[i]n defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits,' SEC v W. J. Howey Co., 328 U.S. 293, 299, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946), and determined that the best way to achieve its goal of protecting investors was 'to define 'the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."
[United Housing Foundation, Inc. v Forman, 421 U.S. 837, 847-848 (1975)] (quoting H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of
'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment" (Reves, 494 U.S. at 60-61).

The UCC is less concerned with frustrating the ingenuity of schemers, and more with providing a workable and predictable code to govern legitimate transactions. The purposes of the UCC are therefore well served by making the line between securities and other interests and obligations as clear as possible -- a clarity that is lacking in federal securities law. The "broad brush" approach of the federal securities laws prompts participants in transactions to err on the side of caution, and to assume -- as the parties in this case did -- that anything near the borderline is a "security" for federal purposes. But the goal of the UCC is to mark the border plainly. Registrability is a test well suited to that goal. It has long been a common practice for issuers of stocks, bonds, notes and other obligations or interests to maintain (or to retain a transfer agent to maintain) books on which the transfers of these obligations and interests may be registered. It is not hard to determine whether such books exist or not. If they do, then "transfer [of the obligation or interest] may be registered upon books maintained for that purpose by or on behalf of the issuer" and the registrability requirement is met.

In this case, no claim is made that McNaughton, the issuer of the notes in suit, maintained (itself or through an agent) transfer books on which transfers of these notes could be registered. McNaughton did have transfer books, and transfers were registered on them -- including transfers of certain classes of promissory notes -- but those books were not available for registering transfers of the notes at issue here. That should end the inquiry: the registrability requirement is not met, and these notes are not securities.

The majority's contrary conclusion rests in part on circular reasoning. It finds that these notes "may be" registered because UCC 8-401 would require registration -- but that section applies only to "a certificated security in registered form." Whether the notes are such securities is the very question the majority is deciding.

The majority also seeks to justify its result by over-emphasizing some words in the statutes describing the registrability requirement and ignoring others. It emphasizes the words "may be" (majority op at 10), which the majority seemingly takes to mean that the notes are registrable if any books could possibly exist in which transfers of the notes could be registered. Read so broadly, the words "may be" deprive the registrability requirement of any meaning -- it is always theoretically possible there could be books on which transfers of anything could be registered. The words "may be registered upon books maintained for that purpose" are much more plausibly read to mean that "books maintained for that purpose" must exist, on which transfers may (or may not) be registered. In other words, the requirement is met whether transfers are actually registered on the books or not, but not if there are no books "maintained for that purpose" on which registration could occur.

The majority ignores the statutory words "maintained for that purpose." It concludes that the registrability requirement is met because, if the notes are transferred and McNaughton is informed of the transfer, it must obviously record the information
somewhere, so that it will have "a way to keep track of the proper payees" (majority op at 12). On this reading of the statute, it is hard to imagine any transferable obligation of any issuer that would not be registrable. The right question is not whether transfers may be reflected in some way in McNaughton's books and records -- of course they may -- but whether they "may be registered upon books maintained for that purpose."

Confusing registrability upon transfer books with recording in corporate books generally was essentially the error criticized, in another context, by a distinguished panel of the Second Circuit Court of Appeals in Gerard v Helvering (120 F2d 235 [2d Cir 1941] [per curiam; L. Hand, Chase and Frank, JJ.]). The issue there was whether payments on a certain bond were a "retirement" of "capital assets" for federal income tax purposes, a question that in turn depended on the registrability of the bond. The court said:

"[the taxpayer] cannot succeed unless [the bond] was 'in registered form,' a phrase whose meaning in this context is entirely plain. It refers to the common practice in the issuance of corporate bonds which allows the holder of one or more coupon bonds of a series the option to surrender them and have one bond 'registered' upon the books of the obligor or of a transfer agent; or the holder may subscribe for such a bond in the first place. The purpose is to protect the holder by making invalid unregistered transfers, and the bond always so provides upon its face. The mere fact that the debtor keeps books of account upon which the debt appears is altogether immaterial; to construe the statute as the taxpayer asks would in effect make the payment of any corporate debt - evidence of indebtedness' -- a 'retirement' of 'capital assets,' for almost all corporations keep books. It is scarcely necessary to labor the answer to so plain a misinterpretation"

(120 F2d at 235-236 [emphasis added]).

I find the majority's error in interpreting the UCC here to be equally plain.

Following certification of a question by the United States Court of Appeals for the Second Circuit and acceptance of the question by this Court pursuant to section 500.27 of the Rules of Practice of the New York State Court of Appeals, and after hearing argument by counsel for the parties and consideration of the briefs and the record submitted, certified question answered in the affirmative. Opinion by Judge Read. Chief Judge Kaye and Judges Ciparick, Graffeo and Jones concur. Judge Smith dissents and votes to answer the certified question in the negative in an opinion in which Judge Pigott concurs.

Decided April 3, 2007

SEcurities AccounT CoNTrol AGREEMENT RETAIL CuSTOMER

Account Control Agreement dated as of , between [Name of Lender/Counterparty] ("Creditor"); [Name of Customer/Pledgor], a [type of entity] ("Debtor"); and [Name of Intermediary] ("Broker"), hereby agree as follows: n1
The arrangement reflected in this agreement is totally voluntary. A securities intermediary is prohibited from entering into a "control agreement" without the consent of the entitlement holder. Conversely, the securities intermediary is not required to enter into such an agreement even though the entitlement holder so directs. § 8-106(g). The term broker-dealer is used here, instead of securities intermediary, because this form was developed taking into account certain comments received from broker-dealers rather than a broader securities intermediary community.

PREAMBLE:
1. Broker has established a securities account, number , in the name of (the "Account"). n2

n2 The establishment of the account might not be evidenced by a written agreement. If it is, the law chosen to govern that agreement will be relevant. See sections 8 and 16 and note 23, below.

2. Debtor has granted Creditor a security interest in the Account pursuant to agreement. n3

n3 The security agreement in this case need not be "written", although such agreements are recommended. See § 9-203(b)(3)(D). Under § 9-203(b)(3)(A) the "written" agreement requirement has been replaced by the requirement that the debtor "authenticate" a security agreement. The securities intermediary need not, and normally will not, be a party to the security agreement. If less than all the assets held or to be held in the account are to be subject to the secured party's security interest, a schedule should be provided to identify the relevant collateral. As a practical matter, however, the parties may prefer to move such assets to a separate account or sub-account. This is likely to be easier operationally for the intermediary and will make it easier for Debtor and Creditor to add or subtract collateral from time to time.

3. Creditor, Debtor and Broker are entering into this Agreement to perfect the security interest of Creditor in the Account.

TERMS:

Section 1. The Account. Broker hereby represents and warrants to Creditor and Debtor that (a) the Account has been established in the name of Debtor as recited above, n4 and (b) except for the claims and interest of Creditor and Debtor in the Account (subject to any claim in favor of Broker permitted under Section 2), Broker does not know of any claim to or interest in the Account. All parties agree that the Account is a "securities account" within the meaning of Article 8 of the Uniform Commercial Code as in effect from time to time in the State of [] (the "UCC") and that all property n5 held by Broker in the Account will be treated as financial assets under the UCC.
However, Creditor and Debtor acknowledge and agree that [specify relevant assets or types of assets] [to the extent so indicated on Account statements, certain assets] are shown on Account statements for informational purposes only. Such assets are neither credited to or carried in the Account nor covered by this Agreement. n6 Broker agrees not to change the name or number of the Account without notifying Creditor and executing any amendments hereto requested by Creditor in connection therewith.

n4 No provision is made for attaching a copy of an account statement, principally to avoid any consequences of oversight at the time of signing. Reviewing such an account statement is likely to be advisable from the point of view of a lender’s diligence, but this can be accomplished independently of the control agreement. As a result, no representation is made by the Broker concerning the contents of the account. However, the parties may desire a different risk allocation, depending on the circumstances. See note 6, below.

n5 It may be appropriate to exclude cash from this representation. Section 8-504 requires that an intermediary have sufficient financial assets to satisfy all security entitlements thereto that it has established in favor of its entitlement holders. If the intermediary agrees to treat cash as a financial asset, it will be agreeing, in effect, to maintain, dollar for dollar, sufficient cash to back up the entitlement. Where the intermediary is a broker-dealer, the regulatory environment may require this in any event. Depository institutions, however, normally maintain underlying cash in this manner only for special deposit accounts.

n6 This sentence protects the intermediary from possible claims by calling attention to the fact that assets shown on an account statement may not be credited to the Account in a manner that gives rise to a security entitlement. Creditor will not be able to obtain control over, or perfect its security interest in, such property by means of this Control Agreement. Any financial assets that are registered in the name of Debtor, payable to his order, or specially endorsed to him, and that have not been endorsed to Broker or in blank, will be considered to be held by Debtor directly, not indirectly through Broker as a securities intermediary. See § 8-501(d). This may arise, for example, with respect to mutual fund shares that Debtor purchases through Broker and that are shown on the account statement as a convenience, but that actually are registered in the name of Debtor on the books of the fund. Similarly, if the Debtor authorizes the intermediary to loan securities in the account to third parties, the account statements prepared by the intermediary may reflect the loaned securities for financial reporting purposes, even though they are not currently maintained in the Account for purposes of the Uniform Commercial Code. In such cases, it will be important for the intermediary to have a method of identifying on the Account statement those securities that technically are not credited to the Account.

Section 2. Priority of Security Interest. Broker hereby acknowledges the security interest granted to Creditor by Debtor. Broker hereby confirms that the Account is a cash account n7 and that it will not advance any margin or other credit to Debtor nor hypothecate any securities carried in the Account except in connection with the settlement of trading activity permitted to be conducted by the Debtor hereunder. n8 Broker hereby subordinates all liens, encumbrances, claims and rights of setoff it may
have, now or in the future, against the Account or any property carried in the Account or any free credit balance in the Account other than in connection with activities in which Debtor is permitted to engage hereunder, including the payment of Broker's customary fees, commissions and other charges pursuant to its agreement with Debtor and for payment or delivery of financial assets purchased or sold for or from the Account. n9

n7 The reference to a "cash" account is meant to exclude "margin" accounts from the scope of this type of arrangement. In addition to business issues that would be presented, margin regulations may limit the extent to which a broker can accommodate a third party's security interest in a "margin" account.

n8 This is not a necessary element for perfecting the Creditor's security interest. Rather, it goes to the business issue of the extent to which the Creditor will allow the intermediary to have its own liens against the Account. To the extent that there may be future trading in the Account, it is highly likely that the intermediary will want to retain its lien.

n9 Without this waiver Broker will have priority over Creditor, irrespective of when Broker's interest arises. See § 9-328(3). Note that adjustment of priorities should be included even if extensions of credit by the Broker are contractually prohibited. Moreover, § 9-206 gives a securities intermediary a purchase money security interest as a matter of law, which would be perfected via § 9-306's operative cross reference to 8-106(e).

Section 3. Control. Broker will comply with entitlement orders (within the meaning of Article 8 of the Uniform Commercial Code of the State of []) (the "UCC") n10 originated by Creditor concerning the Account without further consent by Debtor. n11 Except as otherwise provided in Section 4 below, Broker shall also comply with entitlement orders and other instructions concerning the Account originated by Debtor, n12 or Debtor's authorized representatives, until such time as Creditor delivers a written notice to Broker that Creditor is thereby exercising exclusive control over the Account. n13 Such notice is referred to herein as the "Notice of Exclusive Control." Until Broker receives a Notice of Exclusive Control, Broker may distribute to Debtor all interest and regular cash dividends on property in the Account. n14 After Broker receives a Notice of Exclusive Control and has had a reasonable opportunity to comply, it will cease complying with entitlement orders or other instructions concerning the Account originated by Debtor or its representatives and cease distributing interest and dividends on property in the Account to Debtor. n15 Broker shall be entitled to rely upon any entitlement order or Notice of Exclusive Control that it reasonably believes to be from Creditor. Until it receives a Notice of Exclusive Control, Broker shall be entitled to continue to act on such instructions from Debtor as are delivered in form satisfactory to Broker. n16 Broker has not agreed and will not agree with any third party that Broker will comply with entitlement orders concerning the Account originated by such third party without the prior written consent of Creditor and Debtor. n17
"Entitlement order" is defined in § 8-102(a)(8) to mean "a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement." This can be defined in the agreement, or the requirements for an effective communication can be spelled out.

This language tracks § 8-106(d)(2). There is some concern that conditioning the Creditor's ability to originate entitlement orders upon the occurrence (or the allegation) of an event of default under the underlying security agreement could be viewed as delaying the Creditor's acquisition of control, thus delaying the time of perfection of its security interest. Note, however, that the revised version of Article 9 of the Uniform Commercial Code, which was enacted in all 50 States by July 1, 2001, contained new commentary to § 8-106 which indicated that a Creditor will have control notwithstanding that the Creditor's right to originate entitlement orders is conditioned upon the Debtor's default. See § 8-106, Example 11. The existence of this changed commentary may be considered a "clarification" and as such have current legal significance.

Allowing the Debtor to exercise trading rights does not affect perfection or priority (see § 8-106(f) and comments; §§ 9-314 and 9-328), but may affect credit decisions. The Creditor might wish to limit the nature of the trading or investment permitted by the Debtor, but requiring the Broker to police the Debtor's activity is likely to be perceived by the Broker as unduly burdensome from an operational or monitoring perspective. Accordingly, any such limitations are probably best left to the underlying security agreement -- which has the disadvantage for the Creditor of constituting only a covenant by the Debtor rather than an independently applied limitation.

Obviously, the Creditor will want the right to terminate the Debtor's access to the Account at some point. The Debtor and Creditor should provide in the relevant security agreement for the circumstances under which the Creditor is entitled to send such a notice, which may be before or after default.

This is a business point. The Creditor may wish to require that all such distributions be retained in the Account, but that may present operational concerns for the Broker.

See, in this regard, § 8-115, which affords a securities intermediary a reasonable opportunity to act on an injunction, restraining order or other legal process before incurring liability to adverse claimants. The reference to "other instructions" is intended to terminate all access to the Account by the Debtor--including, for example, issuing instructions to purchase financial assets, which might not fall within the definition of entitlement order (an instruction to "transfer" or "redeem"). Technically, it is not necessary to state that the debtor can continue issuing entitlement orders; provisions are necessary, however, to terminate this right.
n16 Operational and customer relationship concerns may dictate that, so long as the Debtor is free to trade in the Account, Broker will want to leave its manner of communicating with its customer unaffected. On the other hand, acting on instructions from the Creditor may be perceived as an operational change warranting the requirement of a writing. The "Notices" provision contained in Section 14 would impose that requirement.

n17 This provision is essential in order to ensure that the securities intermediary does not comply with a later request by the entitlement holder that it enter into a control agreement with another creditor. If the intermediary did enter into another control agreement, priority would be determined based upon the time that the secured parties take the steps necessary to obtain control. See § 9-328(2). Even though such a secured party would be junior, secured parties generally prefer not to permit the existence of other secured parties without prior consent and the negotiation of appropriate intercreditor provisions.

Section 4. No Withdrawals. n18 Notwithstanding the provisions of Section 3 above, Broker shall not comply with any entitlement order from Debtor requiring a free delivery of any financial assets from the Account nor deliver any such financial assets to Debtor nor pay any free credit balance or other amount owing from Broker to Debtor with respect to the Account, except for the distribution of interest or dividends permitted under Section 3 above, without the prior written consent of Creditor.

n18 The use of the term "withdrawal" appears to be understood in the market to refer to "free deliveries" or other instructions by a customer to deliver securities to a named recipient, as opposed to "trading" in an account, which is accomplished by the Broker executing a trade with a third party. Prohibiting "withdrawals" by Debtor is a business issue. It is not necessary in order for the Creditor to achieve control (and thereby perfection) as a legal matter. If the subject Account were being maintained solely for the purpose of containing collateral, provision might also be required for permitting "substitutions" but this might once again introduce operational issues if the relative values of the financial assets arriving and leaving needed to be compared.

Section 5. Statements, Confirmations and Notices of Adverse Claims. Broker will send copies of all statements and confirmations concerning the Account to each of Debtor and Creditor at the address set forth in the heading of this Agreement. Upon receipt of written notice of any lien, encumbrance or adverse claim against the Account or in any financial asset carried therein, Broker will make reasonable efforts promptly to notify Creditor and Debtor thereof.

Section 6. Limited Responsibility of Broker. Except for permitting a withdrawal or payment in violation of Sections 3 or 4 above or advancing margin or other credit to Debtor in violation of Section 2 above, Broker shall have no responsibility or liability to Creditor for complying with entitlement orders concerning the Account from Debtor or Debtor's authorized representatives which are received by Broker before Broker receives a Notice of Exclusive Control and has had reasonable opportunity to act on it.
Broker shall have no responsibility or liability to Debtor for complying with a Notice of Exclusive Control or complying with entitlement orders concerning the Account originated by Creditor, and shall have no responsibility to investigate the appropriateness of any such entitlement order or Notice of Exclusive Control, even if Debtor notifies Broker that Creditor is not legally entitled to originate any such entitlement order or Notice of Exclusive Control, unless (a) Broker has been served with an injunction, restraining order or other legal process issued by a court of competent jurisdiction (a "Court Order") enjoining it from complying and has had a reasonable opportunity to act on such Court Order, or (b) Broker acts in collusion with Creditor in violating Debtor's rights. n19 Broker shall have no responsibility or liability to Creditor with respect to the value of the Account or any asset held therein. This Agreement does not create any obligation or duty of Broker other than those expressly set forth herein.

n19 These exceptions are probably implicit.

Section 7. Indemnification of Broker. [Debtor and Creditor hereby agree to indemnify n20 and hold harmless Broker, its directors, officers, agents and employees against any and all claims, causes of action, liabilities, lawsuits, demands and damages, including without limitation, any and all court costs and reasonable attorney's fees, in any way related to or arising out of or in connection with this Agreement or any action taken or not taken pursuant hereto, except to the extent caused by Broker's gross negligence or willful misconduct. n21

n20 The willingness of either Creditor or Debtor to indemnify the intermediary may be a subject for negotiation. Such indemnities, although not uncommon, are by no means universal. Market practice appears to have moved towards full indemnity by the Debtor (Broker's customer) and only partial indemnity from Creditor -- e.g., for losses occasioned by acting (or not acting) based on Creditor's instructions to Broker.

n21 Consideration should be given to the appropriate standard for Broker's loss of indemnification--ordinary negligence, gross negligence, etc.

Section 8. Customer Agreement. In the event of a conflict between this Agreement and any other agreement between the Broker and the Debtor, the terms of this Agreement will prevail; provided, however, that this Agreement shall not alter or affect any mandatory arbitration provision currently in effect between Broker and Debtor pursuant to a separate agreement.

Section 9. Termination. [Unless earlier terminated by Broker pursuant to this section,] this Agreement shall continue in effect until Creditor has notified Broker in writing that this Agreement, or its security interest in the Account, is terminated. Upon receipt of such notice the obligations of Broker under Sections 2, 3, 4 and 5 above with respect to the operation and maintenance of the Account after the receipt of such notice shall terminate, Creditor shall have no further right to originate entitlement orders concerning the Account and any previous Notice of Exclusive Control delivered by Creditor shall be deemed to be of no further force and effect. [Broker re-
serves the right, unilaterally, to terminate this Agreement, such termination to be ef-
fective [X] business days' after written notice thereof is given to Debtor and Creditor.

n22

n22 It normally is necessary to provide the Broker with some ability to cease
acting in connection with the Account. On the other hand, simply permitting the
Broker to terminate the control arrangement while the security interest remains
in effect would pose too great a practical risk to the Creditor, unless the Creditor
is free (under its agreement with the Debtor) to either move all the financial as-
sets to its own account or to move the financial assets to another securities in-
termediary with which it has entered into a satisfactory control arrangement.
The terms and conditions of any Broker-initiated termination will need to be ne-
egotiated.

Section 10. Complete Agreement. This Agreement and the instructions and no-
tices required or permitted to be executed and delivered hereunder set forth the en-
tire agreement of the parties with respect to the subject matter hereof, and, subject
to Section 8 above supersede any prior agreement and contemporaneous oral agree-
ments of the parties concerning its subject matter.

Section 11. Amendments. No amendment, modification or (except as otherwise
specified in Section 9 above) termination of this Agreement, nor any assignment of
any rights hereunder (except to the extent contemplated under Section 13 below),
shall be binding on any party hereto unless it is in writing and is signed by each of the
parties hereto, and any attempt to so amend, modify, terminate or assign except pur-
suant to such a writing shall be null and void. No waiver of any rights hereunder shall
be binding on any party hereto unless such waiver is in writing and signed by the
party against whom enforcement is sought.

Section 12. Severability. If any term or provision set forth in this Agreement
shall be invalid or unenforceable, the remainder of this Agreement, other than those
provisions held invalid or unenforceable, shall be construed in all respects as if such
invalid or unenforceable term or provision were omitted.

Section 13. Successors. The terms of this Agreement shall be binding upon, and
shall inure to the benefit of, the parties hereto and their respective corporate succes-
sors or heirs and personal representatives. This Agreement may be assigned by Cred-
itor to any successor of Creditor under its security agreement with Debtor, provided
that written notice thereof is given by Creditor to Broker.

Section 14. Notices. Except as otherwise expressly provided herein, any notice,
order, instruction, request or other communication required or permitted to be given
under this Agreement shall be in writing and deemed to have been properly given
when delivered in person, or when sent by telecopy or other electronic means and
electronic confirmation of error-free receipt is received or upon receipt of notice sent
by certified or registered United States mail, return receipt requested, postage pre-
paid, addressed to the party at the address set forth next to such party's name at the
heading of this Agreement. Any party may change its address for notices in the man-
ner set forth above.
Section 15. Counterparts. This Agreement may be executed in any number of counterparts, all of which shall constitute one and the same instrument, and any party hereto may execute this Agreement by signing and delivering one or more counterparts.

Section 16. Choice of Law. Regardless of any provision in any other agreement relating to the Account, the parties hereto agree that, subject to Section 8 of this Agreement, the establishment and maintenance of the Account, and all interests, duties and obligations with respect to the Account, shall be governed by the law of the State of [ ]. n23 The "securities intermediary's jurisdiction" within the meaning of Article 8 of the UCC shall be the State of [ ]. n24 The parties hereto agree that the law applicable to all issues in Article 2(1) of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary is the law in force in the State of [ ]. n25

n23 This is necessary in order to establish the "securities intermediary's jurisdiction" under § 8-110(e). An alternative approach would be to have a representation about the choice of law in the relevant account agreement and a covenant not to change that choice. We understand, however, that often there is no written account agreement for cash accounts. Therefore, the approach taken in this Agreement is to establish the governing law and thereby the securities intermediary's jurisdiction. Article 9 also explicitly recognizes a specification by a securities intermediary and its entitlement holder as to the jurisdiction that is the "securities intermediary's jurisdiction." See § 8-110(e)(1) (such specification must appear in an agreement "governing the securities account"), which this control agreement would constitute, given its relationship to the Account and any applicable Customer Agreement.

n24 This specification is often included even if the chosen law is the same as the governing law.

n25 Since the Hague Securities Convention has been signed and appears headed for ratification in the U.S. (although it does not by its terms become effective until adopted by three signatory countries) it is useful to include this explicit selection of law so that the transitional rules applicable to pre-existing account agreements will apply and give effect to the parties' choice. The law chosen for Hague purposes should be the same as that selected for "securities intermediary's jurisdiction" purposes but (as with the latter) need not be the same as the law governing the agreement. Note that the selection for Hague purposes will only be given effect if the Broker has an office in the jurisdiction selected -- but if the jurisdiction selected is a state of the United States, the office can be anywhere in the United States. The text of the Hague Securities Convention is available at http://www.hcch.net/index_en.php?act=conventions.text&cid=72 (last visited , 2007).

[Parties may wish to include submission to jurisdiction/consent to service of process provisions as well.]
SIGNATURES: n26

n26 Whether this agreement needs to be written is determined by law other than Article 9.

CREDITOR
By:
Name:
Title:

CUSTOMER

BROKER
By:
Name:
Title:

(Last edited March 7, 2007)

CONFERENCE DE LA HAYE DE DROIT INTERNATIONAL PRIVE
HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW
DIX-NEUVIEME SESSION
NINETEENTH SESSION
ACTE FINAL
FINAL ACT

Final Act of the Nineteenth Session

The undersigned, Delegates of the Governments of Argentina, Australia, Austria, Belarus, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Jordan, Republic of Korea, Lithuania, Luxembourg, Malaysia, Malta, Mexico, Monaco, Morocco, Netherlands, New Zealand, Norway, Panama, Peru, Poland, Portugal, Romania, Russian Federation, Slovakia, Spain, Sri Lanka, Sweden, Switzerland, United Kingdom of Great Britain and Northern Ireland, United States of America, Uruguay, Yugoslavia, Member States, as well as the Representatives of the Governments of Indonesia, Lebanon, Philippines, Thailand, Ukraine, participating as Observers, convened at The Hague from 6-22 June 2001, 22-24 April 2002 and 2-13 December 2002, at the invitation of the Government of the Netherlands, in the Nineteenth Session of the Hague Conference on Private International Law.
Following the deliberations laid down in the records of the meetings, have decided to submit to their Governments -

**A The following draft Convention -**

Constitution on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary

The States signatory to the present Convention,

Aware of the urgent practical need in a large and growing global financial market to provide legal certainty and predictability as to the law applicable to securities that are now commonly held through clearing and settlement systems or other intermediaries,

Conscious of the importance of reducing legal risk, systemic risk and associated costs in relation to cross-border transactions involving securities held with an intermediary so as to facilitate the international flow of capital and access to capital markets,

Desiring to establish common provisions on the law applicable to securities held with an intermediary beneficial to States at all levels of economic development, Recognising that the "Place of the Relevant Intermediary Approach" (or PRIMA) as determined by account agreements with intermediaries provides the necessary legal certainty and predictability,

Have resolved to conclude a Convention to this effect, and have agreed upon the following provisions -

Chapter I – Definitions and Scope of Application

*Article 1 Definitions and interpretation*

1. In this Convention -

   a) "securities" means any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein;

   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) "account holder" means a person in whose name an intermediary maintains a securities account;
e) "account agreement" means, in relation to a securities account, the agreement with the relevant intermediary governing that securities account;

f) "securities held with an intermediary" means the rights of an account holder resulting from a credit of securities to a securities account;

g) "relevant intermediary" means the intermediary that maintains the securities account for the account holder;

h) "disposition" means any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory;

i) "perfection" means completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition;

j) "office" means, in relation to an intermediary, a place of business at which any of the activities of the intermediary are carried on, excluding a place of business which is intended to be merely temporary and a place of business of any person other than the intermediary;

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 authorised to administer a reorganisation or liquidation, including one authorised on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law;

m) "Multi-unit State" means a State within which two or more territorial units of that State, or both the State and one or more of its territorial units, have their own rules of law in respect of any of the issues specified in Article 2(1);

n) "writing" and "written" mean a record of information (including information communicated by teletransmission) which is in tangible or other form and is capable of being reproduced in tangible form on a subsequent occasion.

2. References in this Convention to a disposition of securities held with an intermediary include -

a) a disposition of a securities account;

b) a disposition in favour of the account holder's intermediary;

c) a lien by operation of law in favour of the account holder's intermediary in respect of any claim arising in connection with the maintenance and operation of a securities account.
3. A person shall not be considered an intermediary for the purposes of this Convention merely because -

\( a) \) it acts as registrar or transfer agent for an issuer of securities; or

\( b) \) it records in its own books details of securities credited to securities accounts maintained by an intermediary in the names of other persons for whom it acts as manager or agent or otherwise in a purely administrative capacity.

4. Subject to paragraph (5), a person shall be regarded as an intermediary for the purposes of this Convention in relation to securities which are credited to securities accounts which it maintains in the capacity of a central securities depository or which are otherwise transferable by book entry across securities accounts which it maintains.

5. In relation to securities which 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.

*Article 2 Scope of the Convention and of the applicable law*

1. This Convention determines the law applicable to the following issues in respect of securities held with an intermediary -

\( a) \) the legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account;

\( b) \) the legal nature and effects against the intermediary and third parties of a disposition of securities held with an intermediary;

\( c) \) the requirements, if any, for perfection of a disposition of securities held with an intermediary;

\( d) \) whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest;

\( e) \) the duties, if any, of an intermediary to a person other than the account holder who asserts in competition with the account holder or another person an interest in securities held with that intermediary;

\( f) \) the requirements, if any, for the realisation of an interest in securities held with an intermediary;
g) whether a disposition of securities held with an intermediary extends to entitlements to dividends, income, or other distributions, or to redemption, sale or other proceeds.

2. This Convention determines the law applicable to the issues specified in paragraph (1) in relation to a disposition of or an interest in securities held with an intermediary even if the rights resulting from the credit of those securities to a securities account are determined in accordance with paragraph (1)(a) to be contractual in nature.

3. Subject to paragraph (2), this Convention does not determine the law applicable to:

a) the rights and duties arising from the credit of securities to a securities account to the extent that such rights or duties are purely contractual or otherwise purely personal;

b) the contractual or other personal rights and duties of parties to a disposition of securities held with an intermediary; or

c) the rights and duties of an issuer of securities or of an issuer's registrar or transfer agent, whether in relation to the holder of the securities or any other person.

Article 3 Internationality

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

Chapter II – Applicable Law

Article 4 Primary rule

1. The law applicable to all the issues specified in Article 2(1) is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. The law designated in accordance with this provision applies only if the relevant intermediary has, at the time of the agreement, an office in that State, which -

a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another State -

   i) effects or monitors entries to securities accounts;

   ii) administers payments or corporate actions relating to securities held with the intermediary; or
iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts; or

b) is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.

2. For the purposes of paragraph (1)(a), an office is not engaged in a business or other regular activity of maintaining securities accounts -

a) merely because it is a place where the technology supporting the bookkeeping or data processing for securities accounts is located;

b) merely because it is a place where call centres for communication with account holders are located or operated;

c) merely because it is a place where the mailing relating to securities accounts is organised or files or archives are located; or

d) if it engages solely in representational functions or administrative functions, other than those related to the opening or maintenance of securities accounts, and does not have authority to make any binding decision to enter into any account agreement.

3. In relation to a disposition by an account holder of securities held with a particular intermediary in favour of that intermediary, whether or not that intermediary maintains a securities account on its own records for which it is the account holder, for the purposes of this Convention -

a) that intermediary is the relevant intermediary;

b) the account agreement between the account holder and that intermediary is the relevant account agreement;

c) the securities account for the purposes of Article 5(2) and (3) is the securities account to which the securities are credited immediately before the disposition.

Article 5 Fall-back rules

1. If the applicable law is not determined under Article 4, but it is expressly and unambiguously stated in a written account agreement that the relevant intermediary entered into the account agreement through a particular office, the law applicable to all the issues specified in Article 2(1) is the law in force in the State, or the territorial unit of a Multi-unit State, in which that office was then located, provided that such office then satisfied the condition specified in the second sentence of Article 4(1). In determining whether an account agreement expressly and unambiguously states that the relevant intermediary entered into the account agreement through a particular office, none of the following shall be considered -
a) a provision that notices or other documents shall or may be served on the relevant intermediary at that office;

b) a provision that legal proceedings shall or may be instituted against the relevant intermediary in a particular State or in a particular territorial unit of a Multi-unit State;

c) a provision that any statement or other document shall or may be provided by the relevant intermediary from that office;

d) a provision that any service shall or may be provided by the relevant intermediary from that office;

e) a provision that any operation or function shall or may be carried on or performed by the relevant intermediary at that office.

2. If the applicable law is not determined under paragraph (1), that law is the law in force in the State, or the territorial unit of a Multi-unit State, under whose law the relevant intermediary is incorporated or otherwise organised at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened; if, however, the relevant intermediary is incorporated or otherwise organised under the law of a Multi-unit State and not that of one of its territorial units, the applicable law is the law in force in the territorial unit of that Multi-unit State in which the relevant intermediary has its place of business, or, if the relevant intermediary has more than one place of business, its principal place of business, at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.

3. If the applicable law is not determined under either paragraph (1) or paragraph (2), that law is the law in force in the State, or the territorial unit of a Multi-unit State, in which the relevant intermediary has its place of business, or, if the relevant intermediary has more than one place of business, its principal place of business, at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.

Article 6 Factors to be disregarded

In determining the applicable law in accordance with this Convention, no account shall be taken of the following factors -

a) the place where the issuer of the securities is incorporated or otherwise organised or has its statutory seat or registered office, central administration or place or principal place of business;

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

c) the place where a register of holders of securities maintained by or on behalf of the issuer of the securities is located; or
the place where any intermediary other than the relevant intermediary is located.

Article 7 Protection of rights on change of the applicable law

1. This Article applies if an account agreement is amended so as to change the applicable law under this Convention.

2. In this Article -

   a) "the new law" means the law applicable under this Convention after the change;

   b) "the old law" means the law applicable under this Convention before the change.

3. Subject to paragraph (4), the new law governs all the issues specified in Article 2(1).

4. Except with respect to a person who has consented to a change of law, the old law continues to govern -

   a) the existence of an interest in securities held with an intermediary arising before the change of law and the perfection of a disposition of those securities made before the change of law;

   b) with respect to an interest in securities held with an intermediary arising before the change of law -

      i) the legal nature and effects of such an interest against the relevant intermediary and any party to a disposition of those securities made before the change of law;

      ii) the legal nature and effects of such an interest against a person who attaches the securities;

      iii) the determination of all the issues specified in Article 2(1) with respect to an insolvency administrator in an insolvency proceeding opened after the change of law;

   c) priority as between parties whose interests arose before the change of law.

5. Paragraph (4)(c) does not preclude the application of the new law to the priority of an interest that arose under the old law but is perfected under the new law.

Article 8 Insolvency
1. Notwithstanding the opening of an insolvency proceeding, the law applicable under this Convention governs all the issues specified in Article 2(1) with respect to any event that has occurred before the opening of that insolvency proceeding.

2. Nothing in this Convention affects the application of any substantive or procedural insolvency rules, including any rules relating to -

a) the ranking of categories of claim or the avoidance of a disposition as a preference or a transfer in fraud of creditors; or

b) the enforcement of rights after the opening of an insolvency proceeding.

Chapter III – General Provisions

Article 9 General applicability of the Convention

This Convention applies whether or not the applicable law is that of a Contracting State.

Article 10 Exclusion of choice of law rules (renvoi)

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

Article 11 Public policy and internationally mandatory rules

1. The application of the law determined under this Convention may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum.

2. This Convention does not prevent the application of those provisions of the law of the forum which, irrespective of rules of conflict of laws, must be applied even to international situations.

3. This Article does not permit the application of provisions of the law of the forum imposing requirements with respect to perfection or relating to priorities between competing interests, unless the law of the forum is the applicable law under this Convention.

Article 12 Determination of the applicable law for Multi-unit States

1. If the account holder and the relevant intermediary have agreed on the law of a specified territorial unit of a Multi-unit State -

a) the references to "State" in the first sentence of Article 4(1) are to that territorial unit;
b) the references to "that State" in the second sentence of Article 4(1) are to the Multi-unit State itself.

2. In applying this Convention -

a) the law in force in a territorial unit of a Multi-unit State includes both the law of that unit and, to the extent applicable in that unit, the law of the Multi-unit State itself;

b) if the law in force in a territorial unit of a Multi-unit State designates the law of another territorial unit of that State to govern perfection by public filing, recording or registration, the law of that other territorial unit governs that issue.

3. A Multi-unit State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that if, under Article 5, the applicable law is that of the Multi-unit State or one of its territorial units, the internal choice of law rules in force in that Multi-unit State shall determine whether the substantive rules of law of that Multi-unit State or of a particular territorial unit of that Multi-unit State shall apply. A Multi-unit State that makes such a declaration shall communicate information concerning the content of those internal choice of law rules to the Permanent Bureau of the Hague Conference on Private International Law.

4. A Multi-unit State may, at any time, make a declaration that if, under Article 4, the applicable law is that of one of its territorial units, the law of that territorial unit applies only if the relevant intermediary has an office within that territorial unit which satisfies the condition specified in the second sentence of Article 4(1). Such a declaration shall have no effect on dispositions made before that declaration becomes effective.

Article 13 Uniform interpretation

In the interpretation of this Convention, regard shall be had to its international character and to the need to promote uniformity in its application.

Article 14 Review of practical operation of the Convention

The Secretary General of the Hague Conference on Private International Law shall at regular intervals convene a Special Commission to review the practical operation of this Convention and to consider whether any amendments to this Convention are desirable.

Chapter IV – Transition Provisions

Article 15 Priority between pre-Convention and post-Convention interests

In a Contracting State, the law applicable under this Convention determines whether a person's interest in securities held with an intermediary acquired after this Convention
entered into force for that State extinguishes or has priority over another person's interest acquired before this Convention entered into force for that State.

Article 16 Pre-Convention account agreements and securities accounts

1. References in this Convention to an account agreement include an account agreement entered into before this Convention entered into force in accordance with Article 19(1). References in this Convention to a securities account include a securities account opened before this Convention entered into force in accordance with Article 19(1).

2. Unless an account agreement contains an express reference to this Convention, the courts of a Contracting State shall apply paragraphs (3) and (4) in applying Article 4(1) with respect to account agreements entered into before the entry into force of this Convention for that State in accordance with Article 19. A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that its courts shall not apply those paragraphs with respect to account agreements entered into after the entry into force of this Convention in accordance with Article 19(1) but before the entry into force of this Convention for that State in accordance with Article 19(2). If the Contracting State is a Multi-unit State, it may make such a declaration with respect to any of its territorial units.

3. Any express terms of an account agreement which would have the effect, under the rules of the State whose law governs that agreement, that the law in force in a particular State, or a territorial unit of a particular Multi-unit State, applies to any of the issues specified in Article 2(1), shall have the effect that such law governs all the issues specified in Article 2(1), provided that the relevant intermediary had, at the time the agreement was entered into, an office in that State which satisfied the condition specified in the second sentence of Article 4(1). A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that its courts shall not apply this paragraph with respect to an account agreement described in this paragraph in which the parties have expressly agreed that the securities account is maintained in a different State. If the Contracting State is a Multi-unit State, it may make such a declaration with respect to any of its territorial units.

4. If the parties to an account agreement, other than an agreement to which paragraph (3) applies, have agreed that the securities account is maintained in a particular State, or a territorial unit of a particular Multi-unit State, the law in force in that State or territorial unit is the law applicable to all the issues specified in Article 2(1), provided that the relevant intermediary had, at the time the agreement was entered into, an office in that State which satisfied the condition specified in the second sentence of Article 4(1). Such an agreement may be express or implied from the terms of the contract considered as a whole or from the surrounding circumstances.

Chapter V – Final Clauses

Article 17 Signature, ratification, acceptance, approval or accession
1. This Convention shall be open for signature by all States.

2. This Convention is subject to ratification, acceptance or approval by the signatory States.

3. Any State which does not sign this Convention may accede to it at any time.

4. The instruments of ratification, acceptance, approval or accession shall be deposited with the Ministry of Foreign Affairs of the Kingdom of the Netherlands, Depositary of this Convention.

Article 18 Regional Economic Integration Organisations

1. A Regional Economic Integration Organisation which is constituted by sovereign States and has competence over certain matters governed by this Convention may similarly sign, accept, approve or accede to this Convention. The Regional Economic Integration Organisation shall in that case have the rights and obligations of a Contracting State, to the extent that that Organisation has competence over matters governed by this Convention. Where the number of Contracting States is relevant in this Convention, the Regional Economic Integration Organisation shall not count as a Contracting State in addition to its Member States which are Contracting States.

2. The Regional Economic Integration Organisation shall, at the time of signature, acceptance, approval or accession, notify the Depositary in writing specifying the matters governed by this Convention in respect of which competence has been transferred to that Organisation by its Member States. The Regional Economic Integration Organisation shall promptly notify the Depositary in writing of any changes to the distribution of competence specified in the notice in accordance with this paragraph and any new transfer of competence.

3. Any reference to a "Contracting State" or "Contracting States" in this Convention applies equally to a Regional Economic Integration Organisation where the context so requires.

Article 19 Entry into force

1. This Convention shall enter into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession referred to in Article 17.

2. Thereafter this Convention shall enter into force -

a) for each State or Regional Economic Integration Organisation referred to in Article 18 subsequently ratifying, accepting, approving or acceding to it, on the first day of the month following the expiration of three months after the deposit of its instrument of ratification, acceptance, approval or accession;
b) for a territorial unit to which this Convention has been extended in accordance with Article 20(1), on the first day of the month following the expiration of three months after the notification of the declaration referred to in that Article.

**Article 20 Multi-unit States**

1. A Multi-unit State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that this Convention shall extend to all its territorial units or only to one or more of them.

2. Any such declaration shall state expressly the territorial units to which this Convention applies.

3. If a State makes no declaration under paragraph (1), this Convention extends to all territorial units of that State.

**Article 21 Reservations**

No reservation to this Convention shall be permitted.

**Article 22 Declarations**

For the purposes of Articles 1(5), 12(3) and (4), 16(2) and (3) and 20 -

a) any declaration shall be notified in writing to the Depositary;

b) any Contracting State may modify a declaration by submitting a new declaration at any time;

c) any Contracting State may withdraw a declaration at any time;

d) any declaration made at the time of signature, ratification, acceptance, approval or accession shall take effect simultaneously with the entry into force of this Convention for the State concerned; any declaration made at a subsequent time and any new declaration shall take effect on the first day of the month following the expiration of three months after the date on which the Depositary made the notification in accordance with Article 24;

e) a withdrawal of a declaration shall take effect on the first day of the month following the expiration of six months after the date on which the Depositary made the notification in accordance with Article 24.

**Article 23 Denunciation**
1. A Contracting State may denounce this Convention by a notification in writing to the Depositary. The denunciation may be limited to certain territorial units of a Multi-unit State to which this Convention applies.

2. The denunciation shall take effect on the first day of the month following the expiration of twelve months after the date on which the notification is received by the Depositary. Where a longer period for the denunciation to take effect is specified in the notification, the denunciation shall take effect upon the expiration of such longer period after the date on which the notification is received by the Depositary.

Article 24 Notifications by the Depositary

The Depositary shall notify the Members of the Hague Conference on Private International Law, and other States and Regional Economic Integration Organisations which have signed, ratified, accepted, approved or acceded in accordance with Articles 17 and 18, of the following -

a) the signatures and ratifications, acceptances, approvals and accessions referred to in Articles 17 and 18;

b) the date on which this Convention enters into force in accordance with Article 19;

c) the declarations and withdrawals of declarations referred to in Article 22;

d) the notifications referred to in Article 18(2);

e) the denunciations referred to in Article 23.

In witness whereof the undersigned, being duly authorised thereto, have signed this Convention.

Done at The Hague, on the ... day of ... 20..., in the English and French languages, both texts being equally authentic, in a single copy which shall be deposited in the archives of the Government of the Kingdom of the Netherlands, and of which a certified copy shall be sent, through diplomatic channels, to each of the Member States of the Hague Conference on Private International Law as of the date of its Nineteenth Session and to each State which participated in that Session.

B The following Decisions on matters pertaining to the Organisation of the work of the Conference -

The Nineteenth Session,

Having regard to the deliberations of the First Commission during its meetings of 21-22 June 2001 and 22-24 April 2002 -
1. a) Decides that the Special Commission on General Affairs and Policy of the Conference shall be convened with greater frequency than to date, in principle at least every two years;

b) Invites the Secretary General to convene meetings of this Special Commission, as necessary;

c) Authorises the Special Commission to take decisions on matters relating to General Affairs and Policy of the Conference.

2. a) Welcomes the Strategic Plan prepared by the Permanent Bureau, submitted to the Member States in March 2002, and supports its main directions, in particular the linking as outlined in the Strategic Plan between the decision process on the work programme of the Conference and that on the budget;

b) Decides that the implementation of the Strategic Plan shall be reviewed on a regular basis and that, depending on the outcome of such reviews, the Strategic Plan as a whole be reviewed on a four year basis.

C The following Decisions on matters pertaining to the Agenda of the Conference -

The Nineteenth Session,

Having regard to the deliberations of the First Commission at its meetings of 21-22 June 2001 and 22-24 April 2002,

1. a) Decides to include in the Agenda for the Twentieth Session the preparation of a new comprehensive convention on maintenance obligations, which would build on the best features of the existing Hague Conventions on this matter and include rules on judicial and administrative co-operation, and requests the Secretary General to continue the preliminary work and to convene a Special Commission for this purpose;

b) Considers to be desirable the participation of non-Member States of the Conference, in particular signatory States to the New York Convention of 20 June 1956 on the Recovery Abroad of Maintenance, and requests that the Secretary General make his best efforts to obtain their participation in this work, and ensure that the processes involved are inclusive, including by the provision if possible of Spanish translation of key documents and facilities for Spanish interpretation at plenary meetings.

2. a) Reconfirms the great importance of harmonising the rules on jurisdiction and recognition and enforcement of judgments in civil and commercial matters on a worldwide basis;

b) Notes that, following the decisions of the First Commission at its meeting of 22-24 April 2002, the Permanent Bureau, assisted by an informal working group, is facilitating an informal working process with a view to preparing a text to be submitted to a
Special Commission followed by a Diplomatic Conference to be held, if possible at the end of 2003, and requests the Secretary General to report on the progress made at the next meeting of the Special Commission on General Affairs and Policy.

3. Decides to retain in the Conference's Agenda for future work -

a) questions of private international law raised by the information society, including electronic commerce, and, without priority -

b) the conflict of jurisdictions, applicable law and international judicial and administrative co-operation in respect of civil liability for environmental damage,

c) jurisdiction, and recognition and enforcement of decisions in matters of succession upon death,

d) jurisdiction, applicable law, and recognition and enforcement of judgments in respect of unmarried couples,

e) the law applicable to unfair competition,

f) the law applicable to assignment of receivables.

4. Requests the Secretary General to convene at appropriate times Special Commissions to study the operation of the Conventions on civil procedure and those Conventions which involve systems of international judicial and administrative co-operation, requests the Permanent Bureau to continue its work on the monitoring, review and support of these Conventions, and in particular -

a) Invites the Secretary General to convene a Special Commission to study the practical operation of the *Hague Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters* and the *Hague Convention of 18 March 1970 on the Taking of Evidence Abroad in Civil or Commercial Matters*, in the light *inter alia* of the impact of electronic means on these Conventions;

b) Invites the Permanent Bureau to study the practical operation of the *Hague Convention of 5 October 1961 Abolishing the Requirement of Legalisation for Foreign Public Documents*, in the light *inter alia* of the impact of electronic means, and, in particular with a view to assessing the need and possibility of developing the legal framework for an electronic *apostille* and an electronic register;

c) Invites the Permanent Bureau to continue its activities in support of the effective operation of the *Hague Convention of 25 October 1980 on the Civil Aspects of International Child Abduction*, including the development of a Guide to Good Practice and measures to improve the operation of the Convention with regard to transfrontier rights of access.
Preliminary Draft Convention on Substantive Rules
Regarding Intermediated Securities
(as adopted by the Committee of Governmental Experts at its third session, held in Rome, 06-15 November 2006)

Introductory Remarks
by the UNIDROIT Secretariat

1. - During the third session of the UNIDROIT Committee of Governmental Experts for the Preparation of a Convention on Substantive Rules regarding Intermediated Securities (the CGE), the Drafting Committee continued its work under its Chairman Mr Hideki Kanda (Japan). Members of the Drafting Committee comprised representatives of the delegations from Belgium, Canada, Chile, a "Nordic" country, France, Germany, Luxembourg, Switzerland, United Kingdom and the United States of America. The Chairman of the Drafting Committee invited observers from the European Commission, the European Central Bank and the Trading Association for the Emerging Markets to participate in its work.

2. - The task of the Drafting Committee was to review the draft articles of the Preliminary draft Convention n1 as approved by the CGE on the occasion of its second session in March 2006 n2. The revision of the text was designed to reflect discussion in the ongoing session of the CGE.

3. - The Drafting Committee held its first meeting on 7 November 2006 and its last meeting on 14 November 2006. On 15 November the text of the preliminary draft Convention n3, including amendments proposed by the Drafting Committee, was laid before the CGE meeting in plenary.

n1 UNIDROIT 2006, Study LXXVIII Doc. 42.

n2 Cf. UNIDROIT 2006, Study LXXVIII Doc. 43, Para 197.

4. As regards the proposed changes to the structure of the draft instrument, the Chairman of the Drafting Committee asked the Secretariat to bring the necessary changes to the text.

5. Following detailed explanation of the proposed amendments by the Chairman of the Drafting Committee, the CGE decided to take the amended text as a basis for further discussion. After the meeting, the UNIDROIT Secretariat reviewed the text from an editorial perspective and changed the numbering of the preliminary draft Convention following the indications given by the Chairman of the Drafting Committee.

6. The revised official text is set out in a marked up version (as against UNIDROIT 2006 Study LXXXVIII Doc. 42) in Appendix 1 infra and in a clean version in Appendix 2 infra. A table of concordance is included as Appendix 3 infra.

Appendix 1

Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities

Chapter I – Definitions, Scope of Application and Interpretation

Article 1

[Definitions]

In this Convention:

[Editor’s note: text within these symbols [O> <O] is overstruck in the source.]

(a) "securities" means any shares, bonds or other financial instruments or financial assets (other than cash) [O> or any interest therein, <O] which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;

(b) "intermediated securities" means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;

([O> b <O]c) "securities account" means an account maintained by an intermediary to which securities may be credited or debited;

([O> c <O]d) "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;

([O> d <O]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);
(O) e (O) "account agreement" means, in relation to a securities account, the agreement (O) with (O) between the account holder and the relevant intermediary governing that securities account;

(O) f "intermediated securities" means the rights of an account holder resulting from a credit of securities to a securities account n1; (O)

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

(O) h "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; (O)

(O) i "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; (O)

(O) j (O)h) "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;

(O) k (O)i) "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;

(O) j(O) l (O)) 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 are treated as forming part of the same issue;

(O) m (O)) "control agreement" means an agreement between an account holder, the relevant intermediary and another person (O) a collateral taker, (O) or, if so permitted by the (O) domestic (O) non-Convention law, an agreement between an account holder and (O) a collateral taker (O) another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions --

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder; (O) 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; <O>

([O> n <O>]i) "designating entry" means an entry in a securities account made in favour of [O> a collateral <O> a person other than the account holder [O> taker <O] in respect of [O> the securities account or in respect of specified <O> intermediated securities [O> securities credited to the securities account, <O> which, under the account agreement, a control agreement [O> or <O], the uniform rules of a securities settlement system or the [O> domestic <O> non-Convention law[O> w <O], has [O> the effect that <O> either or both of the following effects -

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder;[O> , 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; <O>

(m[O> o <O]) ([O> domestic <O> non-Convention law" means the [O> domestic <O> provisions of law [O> of <O> in force in the State whose law is applicable under Article 2, other than those provided in this Convention;

[O> (p) "non-consensual security interest" [to be defined]; <O>

([O> q <O>n) "securities settlement [O> [or clearing] <O> system" means [O> [O> a system [O> ] [an entity] <O> which[O> : <O>-

(i) [O> clears, settles or clears and settles <O>, or clears and settles, --securities transactions;

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

([O> i <O>ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules[O> conducts operations that are supervised [by a regulator that has oversight over its rules and agreements] <O>; and

([iO> v <O>ii] has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement [O> [or clearing] <O> system in a declaration by [O> a <O>the Contracting State the law of which governs the rules of the system;[O> , [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 pub-
licly accessible website of its regulator which also specifies the date on which it first was designated as falling within that category]; <O>

[O> 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; <O]

(o) "securities clearing system" means a system which -

(i) clears, but does not settle, securities transactions through a central counterparty or otherwise;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system;

(p) "uniform rules" means, in relation to a securities settlement system or securities clearing system, rules of that system which are common to the participants or to a class of participants and are publicly accessible.

[O> (r) "collateral taker" means a person to whom a security interest in intermediated securities is granted; <O]

[O> (s) "collateral provider" means an account holder by whom a security interest in intermediated securities is granted; <O]

[O> (t) "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. <O]

n1 [O> 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. <O]

Article 2

[[O> Scope <O] Sphere of application]

This Convention applies where --

(a) the conflict of laws rules [O> of private international law <O] of the forum state designate the law in force in [O> of <O> a Contracting State as the applicable law; or

(b) the circumstances do not involve a choice in favour of any law other than the law in force in the forum state and the forum state is a Contracting State.

Article 3

[Central Securities Depositories]
This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons vis-a-vis the issuer of those securities.

Article [O> 3 <O]

[Principles of interpretation]

[O> 1. - <O] In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application.

[O> 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. <O]

Chapter II – [O> Transfer of Intermediated Securities <O] Rights of the Account Holder

Article [O> 9 <O]

[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 [O> domestic <O] non-Convention law so provides;

(b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 7 or grant an interest under Article 8[O> dispose of the securities in accordance with Articles 4 and 5 <O];

(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, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system [O> and the account agreement; <O]

(d) unless otherwise provided in[O> subject to <O] this Convention, such other rights, including rights and interests in securities, as may be conferred by the [O> domestic <O] 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 an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 7(4), 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, 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.

Chapter III -- Rights of the Account Holder Transfer of Intermediated Securities

Article 4

[Acquisition and disposition of intermediated securities by debit and credit]

1. Subject to Article 11, 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 non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. Subject to Article 11, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

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

[Grant of Security interests in intermediated securities by other methods]

1. - An account holder may grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person collateral taker a security interest in intermediated securities so as to be effective against third parties if by:

(a) the account holder enters into an agreement with the collateral taker that person; and

(b) one of the conditions specified in paragraph 2 applies and the relevant Contracting State has made a declaration in respect of that condition under paragraph 4; and no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

2. - The conditions referred to in paragraph 1(b) are as follows -- 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 if:

(a) the person to whom the interest is granted is 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 in favour of that person has been made and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph; or

(c) a control agreement in favour of that person applies. 

3. - An interest in intermediated securities may be granted under this Article so as to be effective against third parties --

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

(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.
4. A Contracting State may declare that under its non-Convention law --
(a) the condition specified in any one or more of sub- paragraphs (a) to (c) of paragraph 2 is sufficient to render an interest effective against third parties to constitute delivery of intermediated securities to a collateral taker;
(b) .

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;
(c) paragraph 3, or either sub- paragraph of paragraph 3, does not apply;
(d) paragraph 3(b) applies with such modifications 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 9
[Other methods under non-Convention law]
This Convention does not preclude any method provided by the non-Convention law --
(a) for the acquisition or disposition of intermediated securities or of an interest in intermediated securities;
(b) for the creation of an interest in intermediated securities and for making such an interest effective against third parties; other than the methods provided by Articles 7 and 8.
Article 10

[Evidential requirements]

The non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 7 and 8.

Article [O> 8 <O]11

[[O> Lack of authorisation, ineffectiveness <O] Invalidity and reversal]

1. - A debit of securities to a securities account or a designating entry is [O> not effective <O] invalid if[O> unless <O] the relevant intermediary is not 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 [O> a security <O] an interest [O> arising <O] granted under Article 8[O> 5(3) <O], by the person to whom that interest is granted[O> collateral taker <O]; or

(b) by the [O> domestic <O] non-Convention law.

2. - Subject to Article[s] 12 [and 13], [O> T <O]the [O> domestic <O] non-Convention law and, to the extent permitted by the [O> domestic <O] non-Convention law, an account agreement or the uniform rules [O> and agreements governing the operation <O] of a securities settlement [O> [or clearing] <O] system determine -

(a) the validity of a debit, credit or designating entry;

(b) whether a debit, credit or designating entry is liable to be reversed;

(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;

(d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and

(e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition. [O> , may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed. <O]

[O> 3. - Subject to Article 7, the domestic non-Convention law determines -- <O]

[O> (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; <O]

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

Article [O> 7 <O]12

[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 -- <O>

   (a) the account holder is not subject to the adverse claim; <O>
   (b) the account holder is not liable to the holder of the adverse claim; and <O>
   (c) the credit is not ineffecti

   n2 [O> 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). <O]

   1. - Where securities are credited to the securities account of an account holder at a time when the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest -

      (a) the account holder is not subject to the interest of that other person;
      (b) the account holder is not liable to that other person; and
      (c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

   2. - Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 8, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry --

      (a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and
      (b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

   3[O> 2 <O]. - Paragraphs 1 and 2 do[O> es <O] 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.

   3[O> 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. <O]

   4. - For the purposes of this Article -

      (a) "defective entry" means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which
becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

(b) a person [O> acts with knowledge <O> knows of an interest or fact [O> adverse claim <O> if that person-[O> : <O>]

([O> a <O>i] has actual knowledge of [O> the adverse claim <O> the interest or fact; or

([O> b <O>ii] has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists [O> the adverse claim exists <O> and deliberately avoids information that would establish [O> the existence of the adverse claim <O> that this is the case; and

(c) [O> and knowledge received by <O> when the person referred to in (b) is an organisation, it knows of an interest or fact [O> is effective for a particular transaction <O> from the time when [O> it <O> the interest or fact is or ought reasonably to have been brought to the attention of the individual [O> conducting that transaction <O> responsible for the matter to which the interest or fact is relevant.

5. - To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

[O> [5. - Notwithstanding Article 8[(2)], if: <O>]

[O> (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 <O>

[O> (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, <O>

[O> 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: <O>

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

[O> (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 <O>

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

n3 <O>
n3 [O> 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. <O]

[O> 6. - For the purposes of paragraph 5 the acquirer has knowledge that the fur-
ther 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 sig-
nificant probability that it is so made and deliberately avoids information that would
establish that that is the case.] <O]

Article [O> 6 <O]13

[Priority among competing [O> security <O] interests]

1. - This Article determines priority between [O> security <O] interests in the
same intermediated securities which become effective against third parties under Arti-
cle 8.

2. - [O> Security <O] Subject to paragraph 5 and Article 14, interests that become
effective against third parties under Article 8[O> 5(3): <O]

[O> (a) <O] have priority over any [O> security <O] interest that becomes effec-
tive against third parties by any other method permitted by the [O> domestic <O]
non-Convention law [O> other than those provided by Article 5(2) or (3); and <O].

[O> (b) <O]3. - Interests that become effective against third parties under Article
8 rank among themselves according to the time of occurrence of the following events-
[O> : <O]

(a[O> i <O]) if the relevant intermediary is itself the holder of the interest, when
the [O> collateral <O] agreement granting the interest is entered into[O> , if the
relevant intermediary is itself the collateral taker; <O]

(b[O> ii <O]) when a designating entry is made;

(c[O> iii <O]) when a control agreement is entered into, or, if applicable, a notice
is given to the relevant intermediary.

[O> 3 <O]4. - Where an intermediary has an interest that has become effective
against third parties under Article 8 and makes a designation or enters into a control
agreement with the consequence that an interest of another person becomes effective
against third parties, the interest of that other person has priority over the interest of
the intermediary unless that other person and the intermediary expressly agree oth-
wise.[O> enters into a control agreement with a collateral taker or makes a desig-
nating 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). <O]

5[O> 4 <O]. - A non-consensual security interest in intermediated securities arising
or recognised under any rule of the [O> domestic <O] 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 paragraphs 2, 3 and 4 and, to the extent permitted by the domestic non-Convention law, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.

Article 14

[Priority of interests granted by an intermediary]

This Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary that have become effective under Article 8.

Chapter IV - Protection Mechanisms of the Intermediation System

Integrity of the Intermediated Holding System

Article 11

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

The rights of an account holder under Article 9, and an security interest interest that has become effective against third parties under Article 8, 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 15

[Prohibition of upper-tier attachment]

1. - No attachment 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 freez-
ing, 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 [O> 16 <O]18

[Instructions to the intermediary]

1. - [O> Subject to paragraph 2 [and Article 8(1)], a <O] 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 an [O> security <O] interest that has become effective against third parties [O> created <O] under Article [O> 5 <O]8;

(c) subject to Article [O> 15 <O]17, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) any [O> mandatory rule <O] applicable rule of the [O> domestic <O] non-Convention law; and

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

Article [O> 17 <O]19

[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 [O> at least <O] equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains [O> [for account holders] n4. <O].

n4 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. - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must within the time required by the non-Convention law [O> [immediately] [promptly] <O] take such action as is [O> required <O] necessary to ensure that it holds sufficient securities and intermediated securities of that description.

3. - The preceding paragraphs do not affect any provision of the [O> domestic <O] non-Convention law, or, to the extent permitted by [O> subject to <O] the [O> do-
mestic [O] non-Convention law, any provision of the uniform rules of a securities settle-
ment [O] [or clearing] [O] system or of an account agreement, relating to the
method of complying with the requirements of those paragraphs or the allocation of
the cost of ensuring compliance with those [O] the [O] requirements [O] of those
paragraphs [O] or otherwise relating to the consequences of failure to comply with
those requirements.

Article [O] 18 [O]20

[Limitations on obligations and liabilities of intermediaries] [O] Application of do-
mestic non-Convention law and account agreement to obligations of intermediary

1. - The obligations [O] and duties [O] of an intermediary _under this Convention
and the extent of the liability of an intermediary in respect of those obligations [O]
and the extent of the liability of an intermediary [O] are subject to any applicable
provision of the [O] domestic [O] non-Convention law and, to the extent permitted
by [O] that [O] the non-Convention law, the account agreement or the uniform rules
of a securities settlement system.

2. - [An intermediary, including the] [The] operator of a securities settlement sys-
tem, who makes a debit, credit, or designating entry (an "entry") to a securities ac-
count maintained by the [intermediary] [operator] for an account holder is not liable
to a third party who has an interest in intermediated securities and whose rights are
violated by the entry unless --

(a) the [intermediary] [operator] makes the entry after the [intermediary] [oper-
tor] has been served with legal process restraining it from doing so, issued by a court
of competent jurisdiction, and has had a reasonable opportunity to act on that legal
process; or

(b) the [intermediary] [operator] acts wrongfully and in concert with another per-
son to violate the rights of that third party.

3. - Paragraph 2 does not affect any liability of the [intermediary] [operator] -

(a) to the account holder or a person to whom the account holder has granted an
interest that has become effective against third parties under Article 8; or

(b) that arises from an entry which the [intermediary] [operator] is not entitled to
make under Article 18.

4. - The operator of a securities settlement system or securities clearing system to
whose securities account securities are credited and who authorises a matching debit
of those securities to its securities account is not liable to a third party who has an in-
terest in intermediated securities and whose rights are violated by that credit or debit
unless --

(a) the operator receives the credit or authorises the debit after the operator has
been served with legal process restraining it from doing so, issued by a court of com-
petent jurisdiction, and has had a reasonable opportunity to act on that legal process; or
(b) the operator acts wrongfully and in concert with another person to violate the rights of that third party.

**Article [O> 19 <O]21**

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

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 [O> that <O] the former 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 account holders other than itself.

2. - Subject to Article 14, 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 [O> its uns <O]ecured creditors [O> in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of unsecured creditors <O] of the intermediary.

3. - Subject to paragraph 4, the allocation required by paragraph 1 shall be effected by the [O> domestic <O] non-Convention law and, [O> subject to the domestic <O] to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities in segregated form --

   (a) for the benefit of its account holders generally; or

   (b) for the benefit of particular account holders or groups of account holders; in such manner as to ensure that such securities are allocated in accordance with paragraph 1.

5. - A Contracting State may declare that under its [O> domestic <O] non-Convention law the allocation required by paragraph 1 applies only to securities--that are held by the relevant intermediary in segregated form under arrangements such as are referred to in paragraph 4[O> with another intermediary under an arrangement for the segregation of securities held by the relevant intermediary for the benefit of its account holders <O] and does not apply to securities held [O> with another intermediary <O] by the relevant intermediary for its [O> for the relevant intermediary's <O] own account.

**Article [O> 20 <O]22**

**[Loss sharing in case of insolvency of the intermediary]**

1. - In any insolvency proceeding in respect of an intermediary, if 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, the shortfall shall be allocated: <O]
(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; or

(b) where the intermediary is a securities settlement 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. - [Unless otherwise provided by the domestic non-Convention law,] 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.

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

1. - This article applies in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.

2. - If the aggregate number or amount of securities of any description allocated under Article 21 to an account holder, a group of account holders or the intermediary's account holders generally is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally (as the case may be), the shortfall shall be borne --

(a) where securities have been allocated to a single account holder, by that account holder;

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. - To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

Any provision of the rules or agreements governing the operation of a securities settlement 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].
Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement system

1. - To the extent permitted by the non-Convention law, the following provisions shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the relevant system or any participant in the relevant 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) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision 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 under any rule applicable in an insolvency proceeding by mandatory operation of the insolvency law of a Contracting State.

Chapter V – Relationship with Issuers of Securities

Article 24

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 in accordance with Article 5 of the rights attached to such securities which are so held, but need not require that all such securities be issued on terms that permit them to be held through intermediaries. 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 such securities by a person acting in his own name on behalf of another person (including a nominee) or other persons 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; but this Convention
does not determine the conditions under which such a person is authorised to exercise such rights.

3. This Convention does not determine whom an issuer is required to recognise as the holder of securities.

Article [O> 14 <O]25

[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 [O> with <O] an intermediary or 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 an intermediary.

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


n5 Further consideration will be given to the terminology of this Chapter and its consistency with that of the remainder of the preliminary draft Convention.

Article [O> 23 <O]26

[Scope and interpretation in Chapter [O> V <O] VI]

1. This Chapter applies to collateral agreements under which a collateral provider [O> delivers <O] grants a security interest in intermediated securities to a collateral taker [O> under Article 5(2) or Article 5(3) <O] in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

2. In this Chapter --

(a) "collateral agreement" means a security collateral agreement or a title transfer collateral agreement;

(b) "security collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of an interest other than full ownership in intermediated securities for the purpose of securing the performance of relevant obligations;

(c) "title transfer collateral agreement" means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of full ownership of intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations;
(d) "relevant obligations" means any present or future obligations of a collateral provider or a third person;[O> "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; <O]

(e) "collateral securities" means intermediated securities delivered under a collateral agreement;

(c) "secured obligations" means the obligations secured by a collateral agreement. <O]

(f) "collateral taker" means a person to whom an interest in intermediated securities is granted under a security collateral agreement or to whom full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(g) "collateral provider" means an account holder by whom an interest in intermediated securities is granted under a security collateral agreement or full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(h) "enforcement event" means, in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision;

(i) "equivalent collateral" means securities of the same description as collateral securities;

(j) "close-out netting provision" means a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, 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:

(i) 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;

(ii) 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.

Article 27

[Recognition of title transfer collateral agreements]

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, that obligation and the relevant obligations may be the subject of a close-out netting provision.

Article [O> 24 <O]28

[Enforcement]
1. - On the occurrence of an enforcement event, the collateral taker may --
(a) realise the collateral securities provided under a security collateral agreement:
((O> a <O)) by selling them and applying the net proceeds of sale in or towards
the discharge of the [O> secured <O]relevant obligations; or
((O> b <O>)ii) 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 relevant[O> secured <O] obligations, provided that the collateral
agreement provides for realisation in this manner and specifies the basis on which col-
lateral securities are to be valued for this purpose; or
(b) operate a close-out netting provision.[O> . <O]

2. - Collateral securities may be realised, and a close-out netting provision may be
operated, under paragraph 1:
(a) subject to any contrary provision of the collateral agreement, without any re-
quirement that:
(i) prior notice of the intention to realise or operate the close-out netting provision
shall have been given;
(ii) the terms of the realisation or the operation of the close-out netting provision
be approved by any court, public officer or other person; or
(iii) the realisation be conducted by public auction or in any other prescribed ma-
nner or the close-out netting provision be operated in any prescribed manner; and
(b) notwithstanding the commencement or continuation of an insolvency procee-
ding in respect of the collateral provider or the collateral taker.

[O> 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 follow-
ing shall occur, or may at the election of the collateral taker occur, whether through
the operation of netting or set-off or otherwise: <O]

[O> (a) the respective obligations of the parties are accelerated so as to be imme-
diately due and expressed as an obligation to pay an amount representing their esti-
mated current value or are terminated and replaced by an obligation to pay such an
amount; <O]

[O> (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. <O]

[O> 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. <O]

Article [O> 25 <O]29

[Right to use collateral securities under security collateral agreement]
1. If and to the extent that the terms of a security 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 relevant 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 equivalent collateral or, where the security 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 relevant 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 security 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 security 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 security collateral agreement.

**Article 30**

[Requirements of non-Convention law relating to enforcement]

Articles 27, 28 and 29 do not affect any requirement of the 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 31**

[Top-up or substitution of collateral]

1. Where a collateral agreement includes:

   (a) an obligation to deliver additional collateral securities --

      (i) 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 relevant obligations;

      (ii) in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed; or, 


(iii) to the extent permitted by the [O] applicable <O] non-Convention law [O] as determined by the private international law rules of the forum, <O] in any other circumstances specified in the collateral agreement.[O] ; or <O]

(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 [O] secured <O]relevant -obligations have been incurred.

2. - A contracting State may declare that paragraph 1(a)(ii) does not apply.

Article [O] 27 <O]32

[Declarations in respect of Chapter [O] V <O] VI]

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

2. - A Contracting State may declare that under its [O] domestic <O] 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 [O] secured <O] relevant obligations falling within such categories as may be specified in the declaration.

Chapter VII – Final Clause

Article X

[Applicability of Declarations]

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the non-Convention law.

Appendix 2

Preliminary Draft Convention on Substantive Rules Regarding 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) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;

(b) "intermediated securities" means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;

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

(d) "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;

(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 between the account holder and the relevant intermediary governing that securities account;

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

(h) "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;

(i) "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;

(j) 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 are treated as forming part of the same issue;

(k) "control agreement" means an agreement between an account holder, the relevant intermediary and another person, or, if so permitted by the non-Convention law, an agreement between an account holder and another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions --

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;
(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder;

(i) "designating entry" means an entry in a securities account made in favour of a person other than the account holder in respect of intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, has either or both of the following effects --

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder;

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

(n) "securities settlement system" means a system which-

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

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement system in a declaration by the Contracting State the law of which governs the rules of the system;

(o) "securities clearing system" means a system which-

(i) clears, but does not settle, securities transactions through a central counterparty or otherwise;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system;

(p) "uniform rules" means, in relation to a securities settlement system or securities clearing system, rules of that system which are common to the participants or to a class of participants and are publicly accessible.
Article 2

[Sphere of application]

This Convention applies where -

(a) the conflict of laws rules of the forum state designate the law in force in a Contracting State as the applicable law; or

(b) the circumstances do not involve a choice in favour of any law other than the law in force in the forum state and the forum state is a Contracting State.

Article 3

[Central Securities Depositories]

This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons vis-à-vis the issuer of those securities.

Article 4

[Principles of interpretation]

In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application.

CHAPTER II -- RIGHTS OF THE ACCOUNT HOLDER

Article 5

[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 non-Convention law so provides;

(b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 7 or grant an interest under Article 8;

(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, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;

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

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 an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 7(4), the non-Convention law determines any limits on the rights described in paragraph 1.

Article 6

[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 5(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.

Chapter III – Transfer of Intermediated Securities

Article 7

[Acquisition and disposition by debit and credit]

1. - Subject to Article 11, 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 non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - Subject to Article 11, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

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

Article 8

[Grant of interests in intermediated securities by other methods]

1. - An account holder grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person so as to be effective against third parties if -

(a) the account holder enters into an agreement with that person; and
(b) one of the conditions specified in paragraph 2 applies and the relevant Contracting State has made a declaration in respect of that condition under paragraph 4; and no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

2. - The conditions referred to in paragraph 1(b) are as follows -
   (a) that the person to whom the interest is granted is the relevant intermediary;
   (b) that a designating entry in favour of that person has been made;
   (c) that a control agreement in favour of that person applies.

3. - An interest in intermediated securities may be granted under this Article so as to be effective against third parties -
   (a) in respect of a securities account (and such an interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account);
   (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.

4. - A Contracting State may declare that under its non-Convention law -
   (a) the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 2 is sufficient to render an interest effective against third parties;
   (b) this Article shall not apply in relation to interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;
   (c) paragraph 3, or either sub-paragraph of paragraph 3, does not apply;
   (d) paragraph 3(b) applies with such modifications as may be specified in the declaration.

5. - The non-Convention law determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties.

   Article 9
   [Other methods under non-Convention law]
   This Convention does not preclude any method provided by the non-Convention law -
   (a) for the acquisition or disposition of intermediated securities or of an interest in intermediated securities;
   (b) for the creation of an interest in intermediated securities and for making such an interest effective against third parties; other than the methods provided by Articles 7 and 8.

   Article 10
   [Evidential requirements]
The non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 7 and 8.

**Article 11**

*[Invalidity and reversal]*

1. A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not 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 an interest granted under Article 8, by the person to whom that interest is granted; or

   (b) by the non-Convention law.

2. Subject to Article[s] 12 [and 13], the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system determine -

   (a) the validity of a debit, credit or designating entry;

   (b) whether a debit, credit or designating entry is liable to be reversed;

   (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;

   (d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and

   (e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.

**Article 12**

*[Acquisition by an innocent person of intermediated securities]*

1. Where securities are credited to the securities account of an account holder at a time when the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest -

   (a) the account holder is not subject to the interest of that other person;

   (b) the account holder is not liable to that other person; and

   (c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

2. Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 8, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry -
(a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and

(b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3. - Paragraphs 1 and 2 do 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. - For the purposes of this Article -

(a) "defective entry" means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

(b) a person knows of an interest or fact if that person -

(i) has actual knowledge of the interest or fact; or

(ii) has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case; and

(c) when the person referred to in (b) is an organisation, it knows of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant.

5. - To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

Article 13

[Priority among competing interests]

1. - This Article determines priority between interests in the same intermediated securities which become effective against third parties under Article 8.

2. - Subject to paragraph 5 and Article 14, interests that become effective against third parties under Article 8 have priority over any interest that becomes effective against third parties by any other method permitted by the non-Convention law.

3. - Interests that become effective against third parties under Article 8 rank among themselves according to the time of occurrence of the following events -

(a) if the relevant intermediary is itself the holder of the interest, when the agreement granting the interest is entered into;

(b) when a designating entry is made;

(c) when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary.
4. - Where an intermediary has an interest that has become effective against third parties under Article 8 and makes a designation or enters into a control agreement with the consequence that an interest of another person becomes effective against third parties, the interest of that other person has priority over the interest of the intermediary unless that other person and the intermediary expressly agree otherwise.

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

6. - As between persons entitled to any interests referred to in paragraphs 2, 3 and 4 and, to the extent permitted by the non-Convention law, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.

Article 14

[Priority of interests granted by an intermediary]

This Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary that have become effective under Article 8.

Chapter IV – Integrity of the Intermediated Holding System

Article 15

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

The rights of an account holder under Article 5(1), and an interest that has become effective against third parties under Article 8, are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 16

[Effects of insolvency]

Subject to Article 23 and Article 31, 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 17

[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, ad-
ministrative 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 18

[Instructions to the intermediary]

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 an interest that has become effective against third parties under Article 8;

(c) subject to Article 17, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

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

(e) where the intermediary is the operator of a securities settlement system, the uniform rules of that system.

Article 19

[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 equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains.

2. - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must within the time required by the non-Convention law take such action as is necessary to ensure that it holds sufficient securities and intermediated securities of that description.

3. - The preceding paragraphs do not affect any provision of the non-Convention law, or, to the extent permitted by the non-Convention law, any provision of the uniform rules of a securities settlement system or of an account agreement, relating to the method of complying with the requirements of those paragraphs or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.

Article 20

[Limitations on obligations and liabilities of intermediaries]

1. - The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Convention law and, to the extent permitted by the non-
Convention law, the account agreement or the uniform rules of a securities settlement system.

2. - [An intermediary, including the] [The] operator of a securities settlement system, who makes a debit, credit, or designating entry (an "entry") to a securities account maintained by the [intermediary] [operator] for an account holder is not liable to a third party who has an interest in intermediated securities and whose rights are violated by the entry unless -

(a) the [intermediary] [operator] makes the entry after the [intermediary] [operator] has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

(b) the [intermediary] [operator] acts wrongfully and in concert with another person to violate the rights of that third party.

3. - Paragraph 2 does not affect any liability of the [intermediary] [operator] -

(a) to the account holder or a person to whom the account holder has granted an interest that has become effective against third parties under Article 8; or

(b) that arises from an entry which the [intermediary] [operator] is not entitled to make under Article 18.

4. - The operator of a securities settlement system or securities clearing system to whose securities account securities are credited and who authorises a matching debit of those securities to its securities account is not liable to a third party who has an interest in intermediated securities and whose rights are violated by that credit or debit unless -

(a) the operator receives the credit or authorises the debit after the operator has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

(b) the operator acts wrongfully and in concert with another person to violate the rights of that third party.

Article 21

[Allocation of securities to account holders' rights]

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 the former 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 account holders other than itself.

2. - Subject to Article 14, 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 creditors of the intermediary.
3. - The allocation required by paragraph 1 shall be effected by the non-Convention law and, to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities in segregated form -

(a) for the benefit of its account holders generally; or

(b) for the benefit of particular account holders or groups of account holders; in such manner as to ensure that such securities are allocated in accordance with paragraph 1.

5. - A Contracting State may declare that under its non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary in segregated form under arrangements such as are referred to in paragraph 4 and does not apply to securities held by the relevant intermediary for its own account.

Article 22

[Loss sharing in case of insolvency of the intermediary]

1. - This article applies in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.

2. - If the aggregate number or amount of securities of any description allocated under Article 21 to an account holder, a group of account holders or the intermediary’s account holders generally is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary’s account holders generally (as the case may be), the shortfall shall be borne -

(a) where securities have been allocated to a single account holder, by that account holder;

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. - To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

Article 23

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

1. - To the extent permitted by the non-Convention law, the following provisions shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the operator of the relevant system or any participant in the relevant system -
(a) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision 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;

(b) any provision of the uniform rules of a securities settlement system in so far as that provision 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 irrevocable under the rules of the system.

2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur under any rule applicable in an insolvency proceeding.

Chapter V – Relationship with Issuers of Securities

Article 24

[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 in accordance with Article 5 of the rights attached to such securities which are so held, but need not require that all such securities be issued on terms that permit them to be held through intermediaries.

2. - In particular, the law of a Contracting State shall recognise the holding of such securities by a person acting in his own name on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description; but this Convention does not determine the conditions under which such a person is authorised to exercise such rights.

3. This Convention does not determine whom an issuer is required to recognise as the holder of securities.

Article 25

[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 an intermediary or 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 an intermediary.

2. - This Article does not affect any express provision of the terms of issue of the securities.
Chapter VI – Special Provisions with Respect to Collateral Transactions

Article 26

[Scope and interpretation in Chapter VI]

1. - This Chapter applies to collateral agreements under which a collateral provider grants a security interest in intermediated securities to a collateral taker in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

2. - In this Chapter -

(a) "collateral agreement" means a security collateral agreement or a title transfer collateral agreement;

(b) "security collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of an interest other than full ownership in intermediated securities for the purpose of securing the performance of relevant obligations;

(c) "title transfer collateral agreement" means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of full ownership of intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations;

(d) "relevant obligations" means any present or future obligations of a collateral provider or a third person;

(e) "collateral securities" means intermediated securities delivered under a collateral agreement;

(f) "collateral taker" means a person to whom an interest in intermediated securities is granted under a security collateral agreement or to whom full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(g) "collateral provider" means an account holder by whom an interest in intermediated securities is granted under a security collateral agreement or full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(h) "enforcement event" means, in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision;

(i) "equivalent collateral" means securities of the same description as collateral securities;

(j) "close-out netting provision" means a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, 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:
(i) 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;

(ii) 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.

**Article 27**

**[Recognition of title transfer collateral agreements]**

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, that obligation and the relevant obligations may be the subject of a close-out netting provision.

**Article 28**

**[Enforcement]**

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

(a) realise the collateral securities provided under a security collateral agreement:

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

   (ii) 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 relevant 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; or

(b) operate a close-out netting provision.

2. - Collateral securities may be realised, and a close-out netting provision may be operated, 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 or operate the close-out netting provision shall have been given;

   (ii) the terms of the realisation or the operation of the close-out netting provision 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 or the close-out netting provision be operated in any prescribed manner; and

   (b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.
Article 29

[Right to use collateral securities under security collateral agreement]

1. - If and to the extent that the terms of a security collateral agreement so provide, 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 relevant obligations, equivalent collateral or, where the security 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 relevant 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 security 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 security 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 security collateral agreement.

Article 30

[Requirements of non-Convention law relating to enforcement]

Articles 27, 28 and 29 do not affect any requirement of the 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 31

[Top-up or substitution of collateral]

1. - Where a collateral agreement includes:

   (a) an obligation to deliver additional collateral securities -

      (i) in order to take account of changes in the value of the collateral provided under the collateral agreement or in the amount of the relevant obligations;

      (ii) in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed;

      (iii) to the extent permitted by the non-Convention law, in any other circumstances specified in the collateral agreement.
(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 relevant obligations have been incurred.

2. - A Contracting State may declare that paragraph 1(a)(ii) does not apply.

Article 32

[Declarations in respect of Chapter VI]

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

2. - A Contracting State may declare that under its 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 relevant obligations falling within such categories as may be specified in the declaration.

Chapter VII – Final Clauses

Article X

[Applicability of Declarations]

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the non-Convention law.

Appendix 3
Preliminary Draft Convention on substantive rules regarding intermediated securities (November 2006)

Chapter II -- Rights of the account holder

Article 4
Article 5
Article 6

Chapter III -- Transfer of intermediated securities

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Article 14 (new)

Chapter IV -- Integrity of the intermediated holding system

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Article 23

Chapter V -- Relationship with issuers of securities (new)

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Chapter VI -- Special provisions with respect to collateral transactions

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Article X (new)