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**NOTE EXPLICATIVE PORTANT SUR L'ARTICLE 9
DE L'AVANT-PROJET DE CONVENTION SUR LA LOI APPLICABLE A CERTAINS DROITS
SUR DES TITRES DETENUS AUPRES D'UN INTERMEDIAIRE
(« AVANT-PROJET D'AVRIL 2002 » FIGURANT DANS LE DOCUMENT PRELIMINAIRE No 10)**

soumise par le Bureau Permanent

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**EXPLANATORY NOTE ON ARTICLE 9
OF THE PRELIMINARY DRAFT CONVENTION ON THE LAW APPLICABLE
TO CERTAIN RIGHTS IN RESPECT OF SECURITIES HELD WITH AN INTERMEDIARY,
("APRIL 2002 PRELIMINARY DRAFT" CONTAINED IN PRELIMINARY DOCUMENT No 10)**

submitted by the Permanent Bureau

*Document préliminaire No 11 d'avril 2002
à l'intention de la Commission spéciale sur les titres intermédiés*

*Preliminary Document No 11 of April 2002
for the attention of the Special Commission on indirectly held securities*

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* La présente Note explicative est basée sur un Mémoire préparé par Christophe Bernasconi, Guy Morton et Richard Potok, et qui a été présenté au Comité de Rédaction et débattu par celui-ci lors de sa réunion de mars 2002 à Francfort. Le Mémoire a donné lieu à l'ajout des nouvelles dispositions dans l'art. 9 du Doc. prélim. No 10.

* This Explanatory Note is based on a Memorandum prepared by Christophe Bernasconi, Guy Morton and Richard Potok, and which was submitted to and discussed by the Drafting Committee at its meeting in March 2002 in Frankfurt. The Memorandum led to the insertion of the new language of Art. 9 in Prel. Doc. No 10.

Introduction: possible approaches

1. The drafting difficulties of the “Multi-unit State” interpretation clause (Art. 9) stem from the great complexity and number of issues which the provision needs to address. In particular, the provision has to consider the possible permutations of the two limbs of Article 4(2) (*i.e.* the designation of the State where the account is maintained and the proviso (reality test)). The possible permutations are as follows:

- (i) “State” means the same territorial unit of a Multi-unit State in both limbs (Permutation 1);
- (ii) “State” means a particular territorial unit in the designation, but the “Multi-unit State” itself in the reality test (Permutation 2);
- (iii) “State” means the Multi-unit State itself in both limbs (Permutation 3);
- (iv) “State” means the Multi-unit State in the designation but a territorial unit in the “reality test” (Permutation 4).

2. Under Permutation 1, the parties (*i.e.* the account holder and the relevant intermediary) could only designate a particular territorial unit in which the intermediary has an office; however, with a view to alleviate such a restrictive approach, a declaration mechanism could be added, permitting a ratifying State to declare that the proviso of Article 4(2) is fulfilled if the relevant intermediary has an office anywhere in that State (*i.e.* in a different territorial unit than the one designated by the parties; this would lead to the same result as under the principle of Permutation 2, see below).

3. Under Permutation 2, the principle would be that the designation can be in favour of a territorial unit in which the relevant intermediary has no office, provided it has an office anywhere within the Multi-unit State (*i.e.* in any other territorial unit). However, with a view to somewhat limiting such a flexible approach, a declaration mechanism could be added, permitting a ratifying State to declare that the proviso of Article 4(2) is only fulfilled if the relevant intermediary has an office in the territorial unit designated by the parties (this would lead to the same result as under the principle of Permutation 1, see above).

4. Permutation 3 requires at the outset that the Multi-unit State has internal conflict rules¹ determining which of its territorial units is eventually to be regarded as the relevant one for the parties’ designation. Similar to Permutation 2, the principle would be that the relevant intermediary does not need to have an office within the territorial unit designated by the internal conflict rules of the Multi-unit State; however, a declaration mechanism could be added, by which a ratifying State could declare that the proviso of Article 4(2) is only fulfilled if the relevant intermediary has an office in the territorial unit designated by the parties. One has to add that if the Multi-unit State has no internal conflict rules or rules which do not lead to a clear result, Permutation 3 does

¹ The expression “internal conflict rules” refers to rules governing choices between the laws of the various territorial units of a Multi-unit State, or between the laws of such territorial units and those of the Multi-unit State.

not work, since the applicable substantive law could not be determined.² Therefore, one may consider making Permutation 3 available only if the Multi-unit State has made a declaration according to which its internal conflicts rule have to be applied and this declaration contains or is accompanied by a statement identifying the internal conflict rules in question and describing their terms and effect in reasonable detail.

5. Similar to Permutation 3, Permutation 4 could only work if the Multi-unit State has internal conflict rules determining which of its territorial units is eventually to be regarded as the relevant one for the parties' designation. The additional difficulty with Permutation 4, however, is that these internal rules would have to point to a territorial unit in which the intermediary has an office. It is very doubtful whether such an approach could lead to sufficient *ex ante* certainty. Permutation 4 is therefore not considered any further in this Note.

The January 2002 Special Commission

6. During the Special Commission meeting in January 2002, the "Multi-unit State" interpretation clause (Art. 9) was discussed at length. The results of this discussion can be summarised as follows:³

7. There was large consensus among the experts that if the parties have designated a particular territorial unit, this designation should be considered as pointing to this particular territorial unit and not merely leading to the Multi-unit State as a whole. In other words, the principle should be that in the context of a Multi-unit State, the expression "State" in the first limb of Article 4(2) means a territorial unit and not the Multi-unit State itself (the designation does not "stop at the border" of the Multi-unit State). The main argument advanced in favour of this approach was that the examination of both the existence and the content of a Multi-unit State's internal conflict rules could be the source of severe difficulties for foreign practitioners and indeed any foreign person applying the Convention.

8. The majority of experts also stressed that the proviso in the second limb of Article 4(2) should be considered fulfilled if the relevant intermediary has an office anywhere in the Multi-unit State (*i.e.* not necessarily in the territorial unit designated by the parties). There was also consensus that a ratifying State should, however, have the

² For example, an agreement stating merely that the account would be maintained within "the United Kingdom" would not produce a clear result, since it would lead to the application of the current common law rules, the uncertainty of which the adoption of the Convention is designed to cure, in deciding whether the law of England, Scotland or Northern Ireland should apply.

³ See the summary of the Chair in the Minutes No 8, p. 3 and 4.

option to declare that the proviso is only fulfilled if the relevant intermediary has an office in the territorial unit designated by the parties.⁴

9. Furthermore, there was a large majority that a Multi-unit State should have the option to preserve (by way of another declaration) the application of the internal conflict rules applicable in the territorial unit designated. However, it was emphasised that if such a possibility were to be adopted, it would be necessary to ensure information about the applicability of the internal conflict rules. Furthermore, it was also stressed that such a declaration could not change party expectations and therefore should have no retroactive effect.⁵

10. All in all, the discussion held at the Special Commission meeting revealed that the experts had a clear preference for a Multi-unit State interpretation clause based on Permutation 2.

The draft adopted by the Special Commission (Prel. Doc. No 8)

11. In light of these discussions, the Drafting Committee suggested the following draft of Article 9:

Article 9 Determination of applicable law in States with more than one legal system

- (1) In this Convention, "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).
- (2) Where, under Article 4(2), the account holder and the relevant intermediary have agreed that the securities account will be maintained in a Multi-unit State and the relevant intermediary has an office anywhere within that Multi-unit State engaged in a business or other regular activity of maintaining securities accounts, the law applicable to the issues specified in Article 2(1) shall be determined as follows –
 - (a) if the account holder and the relevant intermediary have agreed that the securities account will be maintained within a particular territorial unit of that Multi-unit State, the applicable law is the law of that territorial unit;
 - (b) if the account holder and the relevant intermediary have specified a Multi-unit State but not a particular territorial unit of that Multi-unit State, the applicable law shall be determined by the choice of law rules of that Multi-unit State or, if none, by the law of the State determined by Article 4(4) and paragraph 6(b) of this Article.

⁴ Only one delegation noted that it would prefer the opposite system based on Permutation 1: the principle should be that the proviso is only fulfilled if the relevant intermediary has an office in the territorial unit designated, with a ratifying Multi-unit State having the possibility to declare that the proviso of Art. 4(2) is fulfilled if the relevant intermediary has an office anywhere in that State.

⁵ For instance, if as a result of an agreement pointing to British Columbia Art. 4(2) applies, and Canada were not yet party to the Convention, a subsequent declaration of the Canadian Government that internal conflict rules are to be applied could not lead to the retroactive application of the substantive rules of Ontario.

- (3) A Multi-unit State may declare at the time of signature, ratification, acceptance, approval or accession that paragraph 2(a) applies only if the applicable law is the law of a territorial unit within which the relevant intermediary has an office engaged in a regular activity of maintaining securities accounts.
- (4) A Multi-unit State may declare at the time of signature, ratification, acceptance, approval or accession that if pursuant to paragraph 2(a) the applicable law is the law of a territorial unit, the choice of law rules in force in that territorial unit shall determine whether the substantive rules of law of that territorial unit, of another territorial unit of that Multi-unit State, or of that Multi-unit State apply. Such a declaration shall have no effect on dispositions perfected before that declaration becomes effective.
- [(5) A declaration according to paragraph 4 [may] [shall] be accompanied by information concerning the content of the choice of law rules of that Multi-unit State and of its territorial units. The Permanent Bureau shall then make that information available to interested parties by appropriate means.]
- (6) In relation to a Multi-unit State –
 - (a) the references in Article 4(4), to the State under whose law the relevant intermediary is incorporated or organised or in which it has its place of business or principal place of business are references to the territorial unit under whose law the relevant intermediary is incorporated or organised or in which it has its place of business or principal place of business;
 - (b) if the relevant intermediary is incorporated or organised under the laws of the Multi-unit State and not those of any of the territorial units, the reference in Article 4(4) to the State under whose law it is incorporated or organised shall be treated as a reference to the territorial unit in which is situated its place of business or, if the relevant intermediary has more than one place of business, its principal place of business.

Comments on the draft contained in Prel. Doc. No 8 and proposed changes

12. In the plenary session of the Special Commission meeting in January 2002, there have been suggestions that the draft of Article 9 should be shortened and simplified if possible. This Note therefore tries to come up with an alternative draft. At the outset, however, one has to stress once more that the intrinsic difficulties relating to Article 9 stem from the range of complexity of the points which the provision needs to cover.

13. With a view to shorten the Article, one may suggest moving the definition of “Multi-unit State” to Article 1, which already contains a list of definitions of the key expressions used in the Convention.

14. An explicit clause on how to apply the Convention in relation to a “Multi-unit State” seems necessary only with regard to Article 4, as this is the sole provision in which the expression “State” is part of a genuine connecting factor in the technical PIL sense. As a result, the “Multi-unit State” interpretation clause can be tailored for Article 4, without having to take into account other provisions of the Conventions. The other provisions appear indeed to be unproblematic and self-speaking in this regard. In particular, it is obvious that the reference in Article 3 to a choice between the laws of different States

includes a choice between the laws of a territorial unit of a Multi-unit State and the laws of another State (including of course the laws of a territorial unit of another Multi-unit State).⁶ Similarly, there is no doubt that the reference in Articles 5 and 17bis to the law of the State of the relevant intermediary includes the law of a territorial unit of that State. Finally, the reference in Article 6 to Contracting States includes any territorial unit of a Contracting State.

15. The provision needs to address the situation where the parties (maybe inadvertently) designate a Multi-unit State without specifying any particular territorial unit of this Multi-unit State.

16. In the draft of Article 9 contained in Prel Doc No 8, the option to apply internal conflict rules exists only where the Multi-unit State's law is the applicable law as a result of Article 4(2), but not where it is the result of Article 4(4). This needs to be corrected.

New draft suggested

17. Against the background of the previous comments, the *following new draft* of Article 9 is suggested:

Article 9 Determination of applicable law for Multi-unit States ⁷

(1) In relation to a Multi-unit State, Article 4(2) applies as follows:

- (a) If the account holder and the relevant intermediary have agreed that the securities account is maintained within a specified territorial unit of that Multi-unit State, or at a specified place which is situated within a territorial unit of that Multi-unit State, then:
 - (i) the reference to the agreed State in Article 4(2) is to that territorial unit;
 - (ii) the reference to "that State" in the proviso to Article 4(2) is to the Multi-unit State itself, unless the Multi-unit State has declared that such reference, in its application to that Multi-Unit State, is to a particular territorial unit.
- (b) If the account holder and the relevant intermediary have agreed that the securities account is maintained within the Multi-unit State (without specifying a particular place or a particular territorial unit), the references to that State in Article 4(2) are to the Multi-unit State and the applicable law shall be determined:

⁶ It is worth mentioning that conflicts between the laws of two or more territorial units of one and the same Multi-unit State do not trigger the applicability of the Convention under Art. 3. Such internal conflicts, however, become critical when the genuine conflict of laws provision of the Convention (*i.e.* Art. 4(2)) points to a Multi-unit State. This is precisely the question addressed in Art. 9.

⁷ The applicability of this provision to Regional Economic Integration Organisations will need to be considered.

- (i) if the Multi-unit State has made a declaration under paragraph 3, in accordance with the internal choice of law rules referred to in the declaration; and
 - (ii) otherwise, in accordance with Article 4(4).
- (2) In relation to a Multi-unit State, Article 4(4) applies as follows:
 - (a) the references to the State under whose law the relevant intermediary is incorporated or organised or in which it has its place of business or principal place of business are references to the territorial unit under whose law the relevant intermediary is incorporated or organised or in which it has its place of business or principal place of business;
 - (b) if the relevant intermediary is incorporated or organised under the laws of the Multi-unit State and not those of any of the territorial units of that Multi-unit State, the reference to the State under whose law it is incorporated or organised shall be treated as a reference to the territorial unit in which is situated its place of business or, if the relevant intermediary has more than one place of business, its principal place of business.
- (3) A Multi-unit State may declare that:
 - (a) if the account holder and the relevant intermediary have agreed that the securities account is maintained within the Multi-unit State, without specifying a particular place or a particular territorial unit, the internal choice of law rules in force in the Multi-unit State shall determine whether the substantive rules of law of the Multi-unit State or of a particular territorial unit shall apply;
 - (b) if, as a result either of Article 4(2) or Article 4(4), the applicable law would be the law of one of its territorial units, but under the internal choice of law rules in force in that territorial unit the applicable law would be that of another territorial unit or the Multi-unit State itself, then the substantive rules of law of that other territorial unit or (as the case may be) of the Multi-unit State itself shall apply.
- [(4) Any declaration according to paragraph 3 [may] [shall] be accompanied by information concerning the content of the choice of law rules of that Multi-unit State and of its territorial units. The Permanent Bureau shall then make that information available to interested parties by appropriate means.]
- (5) Any declaration under paragraph 1(a)(ii) or paragraph 3 shall have no effect on dispositions made before that declaration becomes effective.

Examples

In all the following examples, Investor is the account holder and Bank is the relevant intermediary.

Example #1

Investor and Bank have agreed that the securities account will be maintained "in Montreal". Bank has offices in Toronto and Calgary. Canada has not made any declarations.

Under Article 9, the following provisions apply: the "agreement" part falls under subparagraph 1(a)(i), the "proviso" part falls under subparagraph 1(a)(ii). The applicable law is the law of Québec.

Example #2

Like #1, but Canada has made a declaration under Article 9(1)(a)(ii). Therefore, the proviso in Article 4(2) is not fulfilled and the applicable law has to be determined under Article 4(4). This, in turn, means that within Article 9, paragraph 2 is applicable. If Bank is incorporated in Toronto, then the law of Ontario applies; if Bank is incorporated or organized exclusively "under the laws of Canada", the law of the territorial unit in which is situated its (principal) place of business applies.

Commentary: What is the result if Bank is incorporated in London (UK)? In this case, it would appear that the correct answer is English law. A declaration under Article 9(1)(a)(ii) might therefore lead to unexpected results. It is true that thus far, the common understanding has always been that Article 9 cannot lead to *renvoi*, *i.e.* to the designation of the law of another State (including another Multi-unit State or one of its territorial units). One may recall, however, that this fact pattern does not lead to the application of *renvoi stricto sensu* (one does indeed not apply the conflict of laws rules of Canada – which one would it be anyway: the law of Ontario, Alberta or Québec or possibly Federal Canadian law?). The application of English law rather results from the general fall-back rule in Article 4(4) and reflects the desire of a declaring State (*i.e.* Canada in this example) to produce a rigorous application of the proviso in Article 4(2).

Example #3

Investor and Bank have agreed that the securities account will be maintained "in the United States". Bank has an office in New York. The U.S. has not made any declarations.

Article 9(1)(b)(i) does not apply, since the U.S. has not made any declaration. According to Article 9(1)(b)(ii), Article 4(4) applies. This latter provision, in conjunction with Article 9(2), can lead to the application of NY law but only if Bank is incorporated there. Alternatively, it may lead to the law of England if Bank is incorporated in England; this would be a result of the general fall-back rule in Article 4(4) (as described in the commentary to example #2).

Example #4

Investor and Bank have agreed that the securities account will be maintained "in the United States". Bank has an office in New York. The U.S. has made the declaration under Article 9(3)(a), but not under Article 9(3)(b).

The relevant U.S. choice of law rules apply, possibly leading to the law of New York.

Example #5

Investor and Bank have agreed that the securities account will be maintained "in Canada". Canada has made both declarations under Article 9(3).

The solution depends on the Canadian choice of law rules. If, for example, these rules point to Ontario, the substantive rules of Ontario apply.

Commentary: What if the choice of law rules of Ontario point to Québec? The question raised by this fact pattern was not expressly considered by the Drafting Committee during its meeting in Frankfurt. On the basis of the new wording of Article 9(3), however, the designation in favour of the law of Québec has to be ignored: Article 9(3)(a) explicitly states that the internal choice of law rules in force in *the Multi-unit State* shall determine whether the *substantive* rules of law of the Multi-unit State or of a particular territorial unit shall apply. This means (1) that the choice of law rules of Canada (as opposed to the choice of law rules of one of its territorial units) shall determine the applicable law, and (2) that the designation is in favour of the *substantive* rules (as opposed to the internal choice of law rules). In other words, the declaration mechanism embodied in Article 9(3)(b) operates only if the application of the law of one of the Multi-unit State's territorial units results *directly* from either Article 4(2) or Article 4(4), but not if it results indirectly from a declaration according to Article 9(3)(a).

Example #6

There is no (valid) agreement under Article 4(2). Bank is incorporated in Ohio and has no office in NY. The U.S. has not made any declarations.

Under Articles 4(4) and 9(2), Ohio is the applicable law, irrespective of whether or not Bank has offices in the U.S.

Example #7

There is no (valid) agreement under Article 4(2). Bank is incorporated in Ohio and has no office in NY. The U.S. has made the declaration under Article 9(3).

The conflict rules in force in Ohio may lead to the application of the substantive law of New York (even if Bank has no office there).

Example #8

At a time when Canada was not yet a party to the Convention, Investor and Bank have agreed that the securities account will be maintained "in Montréal", although Bank only has an office in Toronto. Then, one year later, Canada becomes a party to the Convention and makes the declaration under Article 9(1)(a)(ii).

Article 9(5) makes sure that the Canadian declaration has no impact on any disposition made before the declaration becomes effective. Therefore, the law of Québec remains the applicable law.