Non-Intermediated Securities: a European View on the Draft UNCITRAL Model Law on Secured Transactions

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1. Introduction

The current ‘acquis international’ regarding securities consists of the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (Hague Securities Convention; HSC)\(^1\) and the UNIDROIT Convention on Substantive Rules for Intermediated Securities (Geneva Securities Convention; GSC)\(^2\). These Conventions both relate to intermediated securities and provide, respectively, conflict of laws and substantive law rules in respect of such securities. The current work by UNCITRAL on non-intermediated securities in the context of its Model Law on Secured Transactions (‘draft Model Law’) is a useful contribution in the quest for a consistent and compatible international legal framework for securities.\(^3\)

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This contribution focuses on the interaction of the rules envisaged by the draft Model Law for non-intermediated securities with those of the EU Financial Collateral Directive (FCD). The FCD is directly relevant to the draft Model Law, as the European rules relate to securities, whether intermediated or not. The FCD also relates to cash and credit claims, but these assets will not be discussed here. It should be noted that the FCD was a major inspiration for the rules set out in Chapter V of the GSC under the heading ‘Special Provisions in Relation to Collateral Transactions’, so that much of what is said on the FCD hereafter is also reflected in Chapter V of the GSC.

2. Purpose and contents of the FCD in a nutshell

The main objective of the FCD is to enhance liquidity in the financial markets. To that end, a range of customary (labelled by some as ‘archaic’) features that are characteristic of security interests and insolvency law are disapplied or relaxed. Article 3 of the FCD disappplies formal requirements relating to the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral thereunder; Articles 4 and 7 envisage simplified mechanisms for enforcement, including close-out netting; Article 5 envisages a ‘right of use’, i.e. a general right of disposal, for the collateral taker (which right is thus not limited to default situations); Article 6 prohibits the re-characterization of a title transfer as a security interest (and thus excludes application of ‘pledge principles’ to fiduciary transfers of title); Article 8 disapplies certain insolvency provisions, notably those relating to the retroactive force of the declaration of insolvency, and envisages the validity of acts also after such a declaration has been made.

5 Credit claims were added to the scope of the FCD in the context of its revision in 2009 (n 4).
6 Kanda et al. (n 2) V-1.
3. Creation, validity, perfection, enforceability, and admissibility in evidence

The FCD relates to both collateral arrangements that are structured on the basis of a transfer and to those based on a security interest.\(^8\) As to the creation, validity, perfection, enforceability, and admissibility in evidence of either type of collateral arrangement, Article 3 of the FCD provides:

\textit{Article 3}

\textbf{Formal requirements}

1. Member States shall not require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of any formal act.

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2. Paragraph 1 is without prejudice to the application of this Directive to financial collateral only once it has been provided and if that provision can be evidenced in writing and where the financial collateral arrangement can be evidenced in writing or in a legally equivalent manner.

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Whereas ‘formal acts’ are therefore not permitted in this context, the FCD does require the provision of financial collateral as well as evidence in writing or in a legally equivalent manner.\(^9\)

4. Priority

The FCD contains no substantive law rules on solving priority conflicts. It should, however, be noted that the insolvency treatment of collateral arrangements in Article 8 FCD in effect

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\(^8\) See the definitions of ‘financial collateral arrangement’, ‘title transfer financial collateral arrangement’, and ‘security financial collateral arrangement’ in Article 2(1)(a)-(c) FCD.

\(^9\) On the provision of financial collateral and the requirement of ‘writing’, see also recital (10) and Articles 1(5), 2(2), and 2(3) FCD.
creates a preferential position for the parties to such arrangements (and the collateral taker in particular) to the detriment of other creditors.

5. **Enforcement**

Articles 4, 5(5), 6(2), and 7 of the FCD contain detailed rules on the enforcement of collateral arrangements. Enforcement may take place by way of sale, appropriation, or close-out netting. The most characteristic feature of the FCD is that these enforcement mechanisms may not be subject to formalities, such as prior notice, approval by a court or other independent entity, a public auction or other prescribed manner. This liberal approach has, however, been corrected in the aftermath of the recent financial crisis. Article 118 of Directive 2014/59/EU (see n 4) envisages that certain restrictions on the enforcement of collateral arrangements (notably a temporary stay and the invalidation of *ipso facto* clauses) are allowed in the context of the recovery and resolution of credit institutions and investment firms.

6. **Applicable law**

Article 9 of the FCD contains conflict of laws rules relating to a range of substantive law issues, including the legal nature and proprietary effects of book entry securities, perfection, effectiveness against third parties, priority, good faith acquisition, and enforcement. Like the Hague Securities Convention, the rules of Article 9 of the FCD are, however, limited to book entry securities. Article 9 refers to the ‘relevant account’ in the book entry system, in which intermediaries play a crucial role, as the relevant connecting factor; such account cannot be a connecting factor in the context of non-intermediated securities.

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10 See Articles 4(4) and 7(2) FCD.


12 See the definitions of ‘book entry securities collateral’ and ‘relevant account’ in Article 2(1)(g)-(h) FCD.
7. **Scope: tradability**

Article 2(1)(e) of the FCD only relates to financial instruments that are ‘negotiable’ or ‘normally dealt in’ on the capital market. Securities that are not tradable thus fall outside the FCD regime (as outlined above in sections 2-6). The reasoning behind this exclusion is that non-tradable instruments cannot contribute to liquidity, such contribution being the main justification for deviating from customary rules of security law and insolvency.

8. **Scope: the opt-out of Article 1(4)(b) of the FCD**

Article 1(4)(b) of the FCD contains the following possibility for Member States to opt out of its regime:

> Member States may exclude from the scope of this Directive financial collateral consisting of the collateral provider’s own shares, shares in affiliated undertakings within the meaning of seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts\(^{(5)}\), and shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider’s business or to own real property.

The main thrust of this provision is that a collateral provider’s own shares or the shares of companies whose financial wellbeing is closely related to that of the collateral provider can be excluded from the scope of the FCD. The underlying rationale is that such shares are likely to be of (very) limited value to a collateral taker when the collateral provider defaults, i.e., at the very moment when such value matters most. Upon the collateral provider’s default, the value of its shares and of those of related enterprises may fall substantially, while there may also no longer be a liquid market for such shares. According to a report by the European Commission, Denmark, Germany, Ireland, and Sweden have made (partial) use of this opt-out.\(^{(13)}\)


9. **Personal scope**

The liberal regime contemplated by the FCD gave rise to lively debate on the appropriate personal scope of the Directive prior to its adoption and during the implementation process. In its current form, the Directive applies where at least one of the parties to a collateral arrangement is a financial market participant, while Member States have the option to limit the scope of the Directive to agreements where both parties qualify as such (thus notably excluding natural persons and non-financial small and medium-sized enterprises).\(^{14}\) Following the financial crisis, there were again calls in the legal literature to limit the scope of the FCD to wholesale financial market participants.\(^{15}\) The underlying policy question is whether the special regime of the FCD, which is justified in that it is intended to promote liquidity, should also be applied in sectors of the economy where liquidity is not a major issue.

10. **Concluding remark**

A major challenge for the drafters of the UNCITRAL Model Law on Secured Transactions would seem to be how to reflect the approach of the EU Financial Collateral Directive, in particular where it concerns limitations of scope (requirement of tradability; possible exclusion of shares of the collateral provider and those of related enterprises; personal scope) and the underlying policy considerations regarding such limitations. Will the Model Law contain a ‘default’ regime, as well as a special regime for transactions enhancing liquidity?

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\(^{14}\) For more detail, see Article 1(2)-(3) FCD. On the implementation thereof in the Member States, see European Commission (n 13) 4.2.1.

\(^{15}\) See, for example, Louise Gullifer, ‘What Should We Do about Financial Collateral?’ (2012) 65 *Current Legal Problems* 377–410, and other sources mentioned in Keijser, Kyrkousi, and Bakanos (n 7) fn 8.