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Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS  
**Financial markets infrastructure**

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**Subject: EU Clearing and Settlement  
Legal Certainty Group  
4<sup>th</sup> meeting: 25 and 26 April 2006  
Summary of action points**

### **1. REPORT ON PROGRESS SINCE LAST MEETING**

The compendium of responses to the Group's questionnaire of March 2005 is basically complete. On the basis of the responses as set out in the compendium an assessment may be made of what legal rules in the Member States represent real barriers to a more efficient post-trade landscape across the EU.

The assessment will be used for the chapter of the report entitled 'Does the problem in fact exist?'

### **2. GENERAL DISCUSSION OF THE DOCUMENT 'FIRST DRAFT REPORT'**

There was a discussion on the conclusions of the work on the seven core issues, in context of the draft report, and discussion of chapter VII (Advice).

Overall, consensus was reached that the treatment of intermediated securities holdings in Member States' substantive laws is currently too diverse and inconsistent across Member States, particularly for cross border transactions. Even within domestic legal systems there is inconsistent legal treatment of intermediated securities rights, for example, the legal uncertainty caused by the domestic laws of certain member states not having any clear rules on the treatment of foreign securities credited to domestic accounts is a concrete barrier to market integration.

Members were asked to provide anecdotal evidence of such legal barriers they had come across in practice, if possible prior to the next meeting.

#### **2.1. The legal effects of book entry**

Consensus was reached that there is a need for new legislation to lay down the legal effects of a 'credit entry' (this expression being used to describe a book entry

that is intended to have valid legal effects), and the Group agreed to advise the Commission accordingly.

The advice will take the form of a basic or minimum set of rights that are created upon the making of a credit entry on an account. It was not important how one named the set of rights, but it was essential to define the substance of the rights. This will assist legal certainty and thus help to make the securities settlement markets less costly and more efficient.

It was further established that, as regards the creation and termination of the rights, they are created upon a credit entry to an account and terminate upon a debit entry to an account - at whatever 'link' these entries occur in the chain of intermediaries. They can thus arise only within the relationship of account provider-account holder, and they exist separately from the 'security' and the relationship between shareholders and issuer.

The content of the rights arising upon a credit entry may be categorised broadly into three groups: proprietary rights; administrative or corporate rights; remedies. This last category would be composed at minimum of a set of protections of the account holder against unlawful transfers (or 'mis-matching') by his account provider, insolvency of the account provider (at whatever level of the chain of intermediated holdings), and non-performance (i.e. failure to credit securities to your account in accord with the contract and instruction).

The legal effects need not be homogeneous, but depend on the function performed by the account provider. The effects of book entry will vary depending on the type of intermediary involved and the purpose for which the entry is being made. Thus, an account holder with an account agreement acquires the set of rights upon a credit entry being made on his account with any intermediary carrying on the business of crediting and debiting accounts ('account provider'). The parties to the account agreement may contract out of the entire set of rights. The power to contract out may be limited by regulation as needed.

Accordingly, the set of rights would not be acquired from intermediaries when acting for the purpose of fulfilling any other function, for example by the 'top tier' CSD when performing the function of "establishing securities in book entry form"<sup>1[1]</sup>; nor by all other entities when maintaining accounts for others as a 'parking' service for clients' securities.

It was discussed at length whether one should conceive of these rights as being immutable within a kind of 'wrapper'. No agreement was reached on this.

It was agreed that a functional approach, along the lines of Unidroit, should be followed, so as to define the legal effects of book entry. Aside from stating what the effects are in broad terms, i.e. the set of basic rights, it should be left to Member States' laws how to doctrinally characterise those rights and how they may be exercised (for example, whether to consider the right of 'disposition' as an *in*

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<sup>1[1]</sup> Here the CSD merely registers the securities holder as the issuer's shareholder, thus getting whatever rights the issuer accords him under his statute and the domestic law. Such 'registration' is not to be confused with a book entry made for the purpose of dealing with the above 'asset-backed' set of rights).

*rem* or as an *in personam* right). This would allow each Member State to define this in accord with its own legal doctrine and traditions. The important thing is to ensure that the EU defined rights are given proper effect at national level. The EU legislation should not install a new legal regime for credit entries but should be limited to the minimum harmonisation of the rights created upon book entry. Members States' laws would need to be amended only to the extent they were incompatible with such rights.

## **2.2. Recognition of indirect holdings**

Upon a credit entry being made to his account the account holder might either hold (i) a 'securities entitlement', (ii) the securities themselves or (iii) a bundle of rights and effects called debits and credits<sup>2[2]</sup>.

There was general reluctance to proposing that what the account holder held was a 'securities entitlement', as this would involve creating a new legal asset out of the 'set of rights', whatever that new asset may be called. This was not seen as necessary or desirable to remove legal uncertainty in this area<sup>3[3]</sup>.

The idea was also rejected that the object of settlement in intermediated systems was the issued security itself (viz. (ii) above).

EU legislation should provide that a credit entry creates a set of rights for the account holder (i.e. (iii) as outlined above). Such an approach would be in line with the current draft Unidroit convention.

Nonetheless, however the bundle of rights was conceived - i.e. as a set of minimum rights or as a new financial asset with its own specific name and legal regime – was not decisive; the market would decide whether the rights would be capable of being traded.

## **2.3. Moment of transfer (of the security)**

This issue does not require to be addressed in EU legislation. This was a matter which required flexibility of treatment, e.g. to address reversals - and was best left to the operational rules of the account provider.

## **2.4. Transfer requirements**

There was no present need for EU legislation in this area. Those member states laws that require both an underlying contract and a credit and a debit entry for the credit to be legally effective could be retained. Such requirements were a matter for the member states.

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<sup>2[2]</sup> On solution (ii), the meeting was divided as to whether the EU regime for the legal effects of book entries should essentially replicate or go further than the draft Unidroit text. Most members were not convinced that any proposal to the Commission should be more ambitious in scope than Unidroit. One member noted that for the market what is traded and how fungible that thing is is a market operations matter. Unidroit is more compatible with the cultural diversity across EU and 'building a bridge' between the LCG work and Unidroit was the task of LCG. There was implicit agreement on this.

Although a few members agreed that the proposals should be more ambitious than Unidroit, most accepted that creating a new asset at EU level would be difficult to implement in Member States' laws.

<sup>3[3]</sup> Although this was strongly advocated by one member.

## **2.5. Scope**

The legal uncertainty surrounding the settlement of securities held outside a settlement systems but settled within a CSD (even if domestic) was also a legal barrier to market integration and should be addressed. This was the case even if the transaction was not cross border. Secondly, EU legislation on legal effects of book entry should be wider in coverage than merely rights or interests in types of securities listed in Annex C of MIFID, which was felt to be too restrictive. All securities and interest in securities capable of being credited to an account should be included.

Matters of regulation were of course strongly needed, but fell outside the scope of this Group's work.

## **2.6. Corporate actions and voting rights**

For the issuer and investor alike it was important to know the date when the investor became its shareholder, but that this did not belong to EU legislation in the area of legal effects of book entry.

However, the duty upon the intermediary to pass down all information to the end investor would be costly and is primarily a corporate law matter for the issuer. Imposing such a duty on the intermediary would expose the issuer to the intermediary's costs. This was a decision which did not fall within the group's mandate.

EU legislation on legal effects of book entry which necessarily affects intermediaries is not the right place for determining the moment when the issuer is freed from his payment obligations to his shareholders. That is a matter for corporate law.

## **2.7. Priorities**

A distinction would need to be made between those priority rules that are essential to protect the integrity of legal effects of book entry and those that were not essential to protect legal effects.

Into the former category – which would require EU legislation – fall the following rules:

- (i) the prohibition of upper tier attachment,
- (ii) the rule that credit entry prevails over any informal (or 'mere consent') disposition of assets held on the account, and
- (iii) certain of the rules on the bona fide purchaser (to be defined). The question of the permissibility of reversals may have to be addressed within these rules.

Furthermore, the current text of the Unidroit draft convention may be usefully employed as a 'testing board' for the group's deliberations on the above rules.

**3. HOW THE GROUP'S ADVICE MIGHT RELATE TO THE DRAFT UNIDROIT CONVENTION**

It was noted that good progress is being made at UNIDROIT and the importance of liaison between the two projects was emphasised.

**4. DISCUSSION ON DATE OF NEXT LEGAL CERTAINTY GROUP MEETING**

The next meeting was agreed upon as being 29 and 30 June.