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**Subject: EU Clearing and Settlement
Legal Certainty Group
Draft advice**

The Legal Certainty Group resolved at its last meeting, April 2006, that it should advise the Commission to seek legislation on the legal effects of a book entry. This paper sets out a draft of that advice for discussion.

Advice of the Legal Certainty Group

The Legal Certainty Group advises that legal uncertainty should be reduced by new legislation on the legal effects of a book entry.

The core principles of that new legislation are set out in this advice. This advice describes the new legislation: it does not aim to suggest drafting for it.

1. CORE PROPOSITIONS

The new legislation is based on the following propositions:

- 1.1. that the new legislation does not replace existing national laws of property unless they are inconsistent with it;
- 1.2. that a book entry on a securities account is a source of legal rights for the investor;
- 1.3. that those rights may be exercised against the account provider;
- 1.4. that, the holding of securities by the account provider in a pool does not prejudice the investor's rights;
- 1.5. that nothing should prohibit or impede direct holding of securities.

2. RIGHTS AND REMEDIES OF INVESTOR

2.1. Investors' rights

2.1.1. Proprietary

- to dispose of the rights by instructing the account provider to make a book entry on the account in favour of the purchaser or other recipient;
- to pledge, charge or otherwise burden the rights by instructing the account provider to make a book entry on the account in favour of the pledgee or other recipient;
- to change the account on which the rights in the security are held, including by changing to a different account provider, and to retrieve the securities by delivery of a certificate or any other means, all as provided for under terms of the securities. .

2.1.2. Administrative or corporate

- to vote the security and to receive dividends, interest and all other income to which holders of the security are entitled; and
- to receive all corporate information to allow effective exercise of those rights as regards the issuer of the security.

2.1.3. Remedies

The investor will also acquire the following remedial rights, which he may exercise against the account provider in the event of the investor incurring a shortfall on the account:

- if the account provider's holding for the investor of securities is insufficient, the right to instruct the account provider to replace the missing securities;
- if the account provider's holding for the investor of securities is insufficient, the right to retrieve the same securities from the account provider's own securities (if it has any),
- if the account provider's holding for the investor of securities is insufficient, the right to instruct the account provider to supply other securities of equal value;
- if the account provider has available financial resources, the right to reimbursement of the value of the securities,
- if the account provider cannot or does not (for any reason) exercise his rights against the upper tier account provider, the right to assume all the rights of the account provider and to exercise the rights directly against the upper tier account holder.

2.2. Name

The rights described in section 2.1 above are called 'Interests in Securities'.

2.3. Other rules protective of Interests in Securities

To ensure interests in securities are sufficiently robust, they must be supported by a minimum number of protective rules.

2.3.1. Rules on Priorities:

Interests in Securities are presumed to be valid and enforceable against the account provider (unless the entry is proved to have been invalid under the conditions set out below).

Interests in Securities have priority over any right, interest or claim of a creditor or third party arising under contract or other obligation that is binding on the account holder or the account provider.

A person who acquires an interest in an account without yet having Interests in Securities has priority over other persons who subsequently acquire an interest in the same account.

In case of shortfall on the account, investors rank equally (pro rata) as between themselves with respect to securities of the same kind.

2.3.2. Bona fide

The investor and third parties should be able to rely on book entries being valid and enforceable (i.e. able to rely on the book entries being true credits and debits) against the account provider. The exact parameters of the bona fide are a matter to be decided upon by policy-makers.

2.3.3. Prohibition of upper tier attachment

A person who has a claim in respect of Interests in Securities may not exercise that claim against any person other than (i) the investor or (ii) the account provider with whom the investor has concluded an account agreement.

2.3.4. Investor's rights in securities are unaffected by account provider insolvency:

The insolvency of the investor's account provider or that of any upper tier account provider shall not affect the Interests in Securities. The Interests in Securities will not form part of the insolvent account provider's property and will thus not be subject to the insolvency proceedings.

2.4. Rule on validity of credit entries

An investor does not acquire Interests in Securities in the event that the entry in the account provider's books is found to be invalid pursuant to the account agreement and applicable law (for example, due to error or fraud). Thus, the legal presumption that the Interests in Securities arise upon an entry to an account is rebuttable.

2.5. Option to prohibit conditional (also known as 'contractual') settlement

Member States may require that account providers, before making any credit entry in favour of an investor, have aggregate holdings designated as holdings for investors that are at least equal to the aggregate book entries in favour of their account holders.

2.6. Duties of the account provider

The duties of account providers are:

- 2.6.1. to maintain a number of securities matching the balance of credits on the its investor's accounts;
- 2.6.2. to pass down all information and rights necessary for the effective enjoyment of Interests in Securities
- 2.6.3. to pass up the chain of account providers the information and instructions of the account holder in exercise of his or her Interests in Securities
- 2.6.4. to follow the investor's instructions (specific or under the terms of an agreement between the account holder and the investor)
- 2.6.5. not to take instructions from persons other than the investor (with certain legally prescribed exceptions).

2.7. Other contractual rights

Interests in Securities are without prejudice to, and leave otherwise unaffected, any other contractual rights of the investor in respect of the securities (e.g. right to compensatory damages) provided the latter do not conflict with Interests in Securities. This also applies to rights to set off.

2.8. Subject to the account agreement

The rights labelled as "Administrative or corporate" (1.1.2 above) and those relating to the mutual rights and duties of the account provider and intermediary may be modified or disapplied by agreement between the two. All other rights are fixed and may not be altered by contract.

3. EXPLANATORY NOTES TO THE NEW LEGISLATION

3.1. Interests in Securities

An investor is a holder of Interests in Securities, which arise upon an entry being made in the books of the account provider. All rights contained within Interests in Securities arise upon a credit entry to an account (provided the entry is valid and enforceable). The investor becomes entitled to the rights as of the moment on which the credit entry is made on the account provider's books and ceases to be entitled to them upon a debit entry being made.

The rights are divided for convenience by the labels proprietary, corporate, and remedial. The rights labelled as proprietary do not displace other proprietary rights arising under domestic law unless they are inconsistent. The rights labelled as corporate may be disapplied in the account agreement. The rights labelled as remedial are needed to protect

the investor against the default of the account provider, meaning unlawful entries being made on the account, account provider insolvency (at whatever level of the chain of intermediated holdings), and non-performance (i.e. failure to credit the rights to the investor's account in accordance with the account agreement and client instructions).

Throughout, the terms 'book entry' and 'credit' are used distinctly. A 'book entry' is to be taken to be the act of altering what is visible on an account. A 'credit' (or a 'debit') is a book-entry that has legal effect.

The appearance of credits on an account represents the creation of Interests in Securities to the benefit of the investor and occurs by an act of the account provider (as opposed to negotiation or assignment as between the account provider and its customer).

Thus, a debit entry in one securities account and a credit entry in a different securities account causes Interests in Securities to disappear and appear in a slightly different form. Interests in Securities are constituted and de-constituted by respectively crediting and debiting accounts, i.e., Interests in Securities do not multiply upon each credit entry, they legally exist only whilst credited to the account of the same account holder.

The nature of the difference referred to above is dictated by contractual arrangements between the crediting account provider and its customer on the one hand, and the debiting account provider and its customer on the other. The nature of the difference is *not* dictated by the particular EU Member State law through which the rights are conferred.

3.2. Scope

3.2.1. Securities

The new legislation should apply to securities and rights in securities, to the extent they can be the subject-matter of book entries. Whether other financial instruments capable of being credited to accounts should be covered by the new regime and, if so, which ones, is not essential to the group's mandate. The new legislation would not be restricted to ISIN bearing securities, nor to listed securities. It would thus be an open ended list

3.2.2. Account providers

The new legislation should apply to all account providers. It is assumed that there will continue to be regulation about which entities may and may not be account providers. The new legislation should cover all, and not merely those who are licensed, so that its protection is not denied to investors \at the very moment they need it most (being the default of an unlicensed account provider).

3.2.3. Investors

Any investor, whether he is the ultimate investor in economic terms or another account provider

3.2.4. Domestic and cross-border

All credits to an account, whether or not cross-border and at whatever level of the chain of intermediaries they are made. In fact the future regime will be most effective in cross-

border trades, as this is where the legal uncertainty is most acute about what exactly is the object of the trade. There is no practical reason to restrict the application of the new legislation to cross-border trades only.

3.2.5. *Cash leg*

The new legislation will not contain rules relating to the cash leg of book-entry settlement.

3.2.6. *Terms of issue*

The terms of issue of securities are to be unaffected.

3.2.7. *Company law*

As to relationship with issuers of securities, corporate actions and voting rights, for current purposes, we assume adoption of the Commission's Proposal for a Directive on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC (Brussels, 05.01.2006 COM(2005) 685 final 2005/0265 (COD)). That is to say, MS laws should recognise the holding of securities by account providers (including nominees) and would recognise account providers as representatives of shareholders of the issuer when exercising corporate actions (pace consent of the account holders).

3.2.8. *CSDs*

The new legislation should not apply to accounts that are at the top of the tier, that is to say those usually maintained by CSDs. Accounts of this type establish the security itself in book-entry form and the account provider is not acting as an intermediary in these cases. The principles set out are otherwise intended to be "CSD-neutral", implying that they apply to CSD intermediary operations in the same way as with any other intermediary.

3.3. Regulation

The new legislation does not cover the way in which regulation of the financial markets, in particular of the activities of account providers, may need to evolve.

It may be noted that the effect of the new legislation will be to increase (in some cases) the legal importance of book entries. It may be that regulation will be required to ensure that account providers may safely take on that new responsibility. For example, authorities may feel prompted to make sure that only 'fit and proper', prudentially-authorized account providers are permitted to operate accounts for others, or to impose regulations about the way in which securities accounts should be operated. This is clearly a policy matter and not intrinsically needed for the efficacy of the regime outlined in these principles. It is, of course, a crucial issue nonetheless.

One further aspect to this issue is the question whether matters which are treated by some as regulatory and by some as substantive should be incorporated as indisputably substantive. For example, some feel that the constitutive effect of a credit should be conditional on there being a corresponding debit, or instruction to debit, another account.

The approach taken in this advice is to leave matters such as rules on reversals, conditionality and effectiveness of book-entries to policy-makers.

3.4. Legislative form

No advice is given at this stage as to legislative form, in particular whether a Directive, an EU Regulation or a Convention would be best. It may be noted that if the draft UNIDROIT Convention, when it has been negotiated, matches the new legislation described here, its ratification will be preferable to any parallel but separate Community instrument.

4. CONCEPTUALISING THE NEW LEGISLATION

4.1. The artificiality of current legal solutions

At present there is artificiality throughout the EU laws dealing with the intermediated holding structure. This is the case both where the law is ownership-based and where it is trust-based. All systems - whether based on trust, pure ownership or the collective custody co-ownership model or mixtures of any of these - have an artificiality in how they are conceived that results from a legal regime that *assumes* that the owner (investor) directly holds the securities and thus has absolute control over them. (This may be compared with dealings on an exchange where brokers act as principals in their mutual dealings, but as agents in their dealings with customers).

In practice the ultimate investor cannot do very much with his ownership except through his account provider – nonetheless the law assumes that the investor remains the owner and so all legal effects within the tiers of holdings merge consistently.

In all legal systems therefore the law has to resort to the same artificialities to take into account how the market works. Even where the law recognises divided ownership, the several tiers turn trustees at one level into beneficiaries at the next and, like owners in the civil law system, beneficiaries at one level can act only in relation to trustees at the next level. The problem is thus the same as in ownership-based legal systems. There is thus no difference between direct and indirect holding systems: what creates this artificiality is that the certificate is not held by the investor under his mattress, but by a third party, which can also be the CSD itself.

One must resort to artificialities to state that the investors are the beneficial owners of securities and can exercise all their rights as beneficial owners. Both systems close their eyes and skip over legal technicalities: they describe the practical situation and do not bother with the need for the law to keep pace with the market.

The artificialities only dissolve upon the account provider's insolvency, when all Member States' laws provide that the investor is clear of the insolvency. However, even in such extreme cases, it is not clear what effective remedy the investor has. What does the owner have legally apart from a claim against the insolvent estate?

The fact is that MS' laws are still not very clear what we have to do to 'transfer', pledge or re-hypothecate assets held through intermediaries (i.e. dealing with derivative rights in securities between accounts). This especially the case when there is a cross border element to the 'transfer' or 'pledge'.

This lack of clarity in the laws may not represent a barrier to a single settlement market *working*, as the market can find (and has found) ways to deal with this legal uncertainty. The market works despite it. The problem is rather that the market does not *work efficiently*; solutions have been emerging in a disjointed fashion. This is a problem in itself because the outcomes are unpredictable within legal systems and more so whenever two legal systems meet. It would thus be beneficial and desirable to replace these fragmented national solutions by means of one EU wide solution.

The new regime must be robust for the sake of investors. It is precisely because shareholders and bond holders are the real owners of the security that our new regime needs to ensure that when account providers hold these security-linked rights for the account of investors, the latter are protected with the same effectiveness as the shareholder's right of ownership.

The new regime must be robust for sake of the market also. From the account holder's standpoint, he must be able to deal with those rights through his accounts separately from the security. In order to accomplish this account providers must have the possibility to hold securities on behalf of third parties and must be able to deal with the assets in the market as if they were the owners of those assets and give good title (that is demanded by certainty and finality); this too the market demands to remain efficient. Indeed their authority to sell must be assumed, otherwise intermediaries would not be able to sell the rights at all as they are only "holders".

The realism of these protections is recognised in all Member States' laws. They all accept that in one way or another, each lower-tier investor or account provider is not exposed to the credit risk of the upper-tier intermediaries, but that each lower-tier investor or account provider needs some sort of cooperation from all of the upper-tier intermediaries in order to enforce its economic and administrative rights against the issuer, the upper-tier intermediaries and any other third party.

Hence strong remedies are required to ensure that the owner (investor) can exercise his rights to this economic asset, which is being held for his account.

4.2. Interests in Securities and ownership of the security

The starting point for understanding the new legislation is the fact that an investor owns the underlying security that is recorded in his name and/or held by him directly or on his behalf at the top tier (usually by a CSD).

The Interests in Securities do not create a "new asset" at the issuer level; they may be dealt with as an asset only at the account provider-investor level. Interests in Securities do not interfere with a shareholder or bondholder (i.e. the ultimate investor in the security) having and continuing to have what is ordinarily regarded as ownership of the underlying security. The account provider is not and does not at any moment become therefore entitled to the Interests in Securities arising from accounts provided by him.

When the account provider is himself in a customer relationship with an upper tier provider, he will be entering into the account agreement with that upper tier provider as an intermediary and not as the end investor. Accordingly, the credit entry on his account will not cause him to become the 'owner' of the securities, but that entry will create Interests in Securities and simultaneous obligations in favour of lower tier clients. The

investor at the lowest tier (the 'end investor') is the owner of securities and is the holder of Interests in Securities.

The entry therefore creates rights only against the account provider which are effected by the entry on the account – they may be exercised by *any* client down the tier but *only* and exclusively against the immediate account provider; in other words no obligations arise for anyone else apart from the account provider as a result of the entry. This conception reflects market reality, namely the fact that the owner-investor in dematerialised securities is at the bottom of an chain of intermediated holdings. Each account provider in the chain of holdings will not know about any other account provider apart from the one with whom he concluded his account agreement. It also reflects the economic reality that the value to the account provider of the entry should be nil - as the owner retains all the economically valuable rights and the account provider is incurring obligations to lower tier clients that balance the rights he gains from upper tier account providers.

Interests in Securities do not replace the rights flowing from the investor's ownership of the security - which is evidenced at the top tier (usually a CSD). Interests in Securities only replicate that ownership at the level of each account provider-client relationship, and as against each account provider, in order to allow intermediaries to deal with those Interests in Securities.

Interests in Securities and ownership of the security are therefore two separate but parallel and compatible worlds. Creation of Interests in Securities does not depend on the investor owning the security in the issuer's register but on the making of a credit (i.e. a valid book entry), just as the security does not depend on any rights existing under the account agreement but on its establishment at the top tier (usually a CSD). (However, the *value* of the Interests in Securities derives from the security issued at the top tier; if the Interests in Securities are to have any economic value the chain of credits must eventually link up with the underlying security.)

As Interests in Securities are clear and separate from the security (the object of ownership), we must define clearly and precisely exactly what Interests in Securities are, in order to move forward. To do so properly, the conceptualisation must take account of the difference between normal ownership rules for movable assets (on which much of property, including pledge law, is based) and the fact that the possibility of exercising the rights in question (and hence their economic value) depends neither on the issuer nor the owner but on a third party (i.e., the account provider).

4.3. A new legal asset?

The fact that the legal effects of a credit will be required by the new legislation to be the same across the EU does not mean that Interests in Securities will be classified in the same manner in each Member State's law. In some MS it is crucial for the law to recognise institutionally what is being pledged or transferred before it can be given full legal effect in that jurisdiction.

Such differences of classification (or national law treatment according to its own imposed classification of the asset) when parties try to deal with Interests in Securities e.g. for sale and purchase or for pledging or re-hypothecation (i.e. to re-use the asset for a further charge), is highly likely to constitute a further legal barrier to the single market.

Accordingly, it may be preferable to classify Interests in Securities as a new legal asset. However, that is a matter for Member States legal systems, and is not a European issue.

There will be no attempt in the Community regime to characterise Interests in Securities, nor to assert for them any particular legal nature. The rules on Interests in Securities aim to lay down the legal effect of a book entry only, and thus follow a functional rather than doctrinal approach.

4.4. Packaging the rights

A further question is whether these rights should be treated as a single set or should be a list of individual rights (*à la* Unidroit). This is the same as the question whether the rights should be named in the legislation that establishes them.

Interests in Securities will need to be inserted into and interact with existing national legal systems; the detailed consequences of that may be unexpected. One legal system may try to interpret it differently from another, raising the fear that it will be 'transferable' and 'pledgable' in some jurisdictions and not in others. The EU emissions rights programme has encountered similar problems. Packaging the rights by naming them will help to avoid this. (Indeed, using the expression Interests in Securities has made it far easier to explain the concepts that arise in this paper).

Packaging would be preferable as it gives the regime the profile necessary to achieve market recognition, so that the law and market practice can proceed hand in hand. It is not mechanically essential to the regime being workable, but it is strategically desirable.

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