

MAJOR EXAMPLES OF LEGAL BARRIERS TO A SINGLE EFFICIENT AND LESS COSTLY POST TRADING MARKET IN EU

(N.B. the examples given below are only illustrations of the types of rules that Member States have in place and that may constitute substantive law barriers to an efficient and integrated securities settlement market)

MEMBER STATES' (MS) LAWS ARTIFICIALLY CATEGORISE THE LEGAL REGIMES FOR INVESTOR RIGHTS IN INTERMEDIATED SECURITIES ; INTO WHICH REGIME THE INVESTOR FALLS IS MADE TO DEPEND ON FACTORS WHICH IN A SINGLE FINANCIAL MARKET SHOULD BE IRRELEVANT.

Several MS laws determine account holder rights within a book entry system depending on whether or not they come within the terms of their domestic legislation on collective custody, i.e. a special legal regime (e.g. Germany - collective custody law, Netherlands - the Giro Admin and Transfer Act, Belgium - Royal Decree 62).

These special legal regimes recognise ownership rights in book entry securities (e.g. the theoretical right to exercise corporate rights directly against the issuer) that are equivalent to ownership of a share certificate only to accountholders that come within the terms of that special regime. If they do not come within the terms of the regime, only the intermediary has the ownership rights in respect of the securities vis à vis the issuer.

If the book entry securities are FOREIGN ISSUED OR ARE HELD ABROAD, THE INVESTOR MAY BE FORCED INTO A REGIME OTHER THAN THE COLLECTIVE CUSTODY REGIME APPLICABLE TO DOMESTIC ISSUES.

An example of this sort of regime is the German WR-Credit law, which is a sub regime for foreign book entry securities held through domestic custodians. The securities are treated *as if* owned by the account holder although they cannot come under the terms of the collective custody law. Under the WR-Credit law however the account holder only has *in personam* rights against the domestic custodian holding the foreign securities in custody for him. If the securities were held under the collective custody law, the account holder would have co-ownership rights in the securities held on the account.

Thus legally foreign issued securities coming under the WG-Credit law (i.e. that do not conform to the German law definition of a 'security') are treated differently from domestic issued securities.

Another example is the Netherlands; that is any regime falling outside the DUTCH GIRO ACT.

As regards Belgium, the ROYAL DECREE of 1962 is the regime for book entries on intermediated accounts, but this regime DOES NOT APPLY to accounts with account providers that are NOT affiliates of a recognised Belgium settlement system (eg Euroclear, NBB).

A similar situation occurs in Austria where account providers under Austrian law cannot transfer co ownership rights in foreign dematerialised securities to the account

holder. Instead the account holder obtains other rights called “Wertpapierrechnung”. That these other rights are substantively the same legal rights for the holder as co ownership of a pool appears to be a matter of legal opinion and not of law.

Some MS also differentiate the legal treatment of the account holder depending on whether the securities are held in a domestic CSD account or in a non CSD intermediary account, regardless of whether they are foreign or domestic (DK, ESP).

If the securities are held on the account of an INTERMEDIARY which IS NOT AN INSTITUTION WHICH IS A PARTICIPANT OF A PRIVILEGED DOMESTIC SETTLEMENT SYSTEM, the investor may not be recognised by domestic law as full owner of the securities vis à vis the issuer.

This is the case with the SPANISH regime, which is based on participation of the intermediary in IBERCLEAR.

In Spain, for example, the investor will have full ownership rights only if he holds his book entry securities through a registered individual account at IBERCLEAR or with a participant in IBERCLEAR. The investor thus has no choice but to keep his account with particular domestic intermediaries, and if he chooses an intermediary which is not participating in IBERCLEAR Spanish law will not accord the same legal effects to his book entry on that account.

This situation argues in favour of a minimum set of legal effects for book entries harmonised at EU level regardless of the status of the intermediary providing the account - in the interests of legal certainty and market efficiency.

INVESTOR RIGHTS IN FOREIGN ISSUED BOOK ENTRY SECURITIES CREDITED TO A DOMESTIC ACCOUNT ARE UNCLEAR IN MANY MS LAWS

This is largely the case in the new member states where the applicable laws tend to assume that the securities are domestically issued (i.e. under domestic law). **Where the securities are not domestically issued, although credited to a domestic CSD account, the legal status of those securities in domestic law is not clear.**

In some MS where the top tier intermediary is a central securities depository or registrar, the domestic book entry legislation will only apply to foreign securities if they are directly registered at such top tier CSD. There is no regulation applying to custody of foreign securities in cases where the domestic book entry legislation is not applicable (e.g. ECSA regime in Estonia). Similarly, in Denmark the Stock Trading Act only applies, to recognise legal effects of book entries vis à vis third parties, if the securities in question are registered at a CSD.

In several MS, especially where the book entries are evidenced in a central securities registry, the arrangement for record keeping and settlement differs for foreign securities from the arrangements applied to domestic securities, e.g. more administratively cumbersome, time consuming (e.g. Slovakia).

DOMESTIC LAW RESTRICTIONS ON WHAT SECURITIES MAY BE CREDITED TO ACCOUNTS SO THAT ACCOUNT HOLDERS ACQUIRE RIGHTS.

There is no definitive, uniform list of all the types of assets that can be credited to an account. The existing MS laws vary widely on this question. The concept "securities" is diverse in meaning across the MS. Even the term 'transferable securities' in MIFID annex C is not free from doubt and it has been diversely implemented across the MS.

Most MS laws (e.g. Austria, Italy, UK, Sweden, Finland, even France) do not have fully dematerialised systems and allow for the issue of securities certificates in some cases.

The assumption that securities are issued in physical form still underpins to some extent the securities laws of many of these MS. Thus the book entry concept has to be applied by analogy to existing legislation which assumes a physical issue of the security.

This has an impact on the way in which these MS laws define which asset or instrument may be credited in a book entry form on an account and thus leads to significant variations in what rights in book entries are recognised from MS to MS.

For example an Austrian account provider is not required by Austrian law to accept into custody assets which do not fall within the legal definition of "securities" (in physical or book entry form). The point is that he may accept them, but he is not required to do so.

In English law, any form of financial asset may be credited to an account, and it is essentially a matter of contract. English law accepts money market instruments as securities, whereas most other EU legal systems do not, and indeed this is reflected in the categorisation of financial instruments in annex C of the MIFID directive. On the other hand, German and Finnish laws accept derivatives as securities if they are issued in certificate form.

If one and the same financial asset can be credited to an account in one MS but cannot be credited to an account in another MS, this represents a substantive law barrier to a single efficient market.

This argues in favour of a broad definition of 'securities account' and what may be credited to such an account.

RESTRICTIONS STEMMING FROM THE LEGAL VALUE GIVEN BY THE MS LAW TO AN ENTRY ON AN ACCOUNT

Some legal systems by legislation expressly equate the legal effects of a credit entry on an account of book entry form dematerialised securities to the legal effects of delivery of securities in physical form, (e.g. Spain).

However, in other legal systems (e.g. Austria is one of the most traditionalist in this respect) the relevant securities law still assumes that the security is physically issued,

i.e. that rights to the security are based on the existence of an underlying note or certificate. In such systems the value and legal characterisation of the book entry tends to be demoted to that of a mere evidential value or book keeping exercise. Legally it is a mere accounting record, but as a matter of practice it represents the perfection of the transfer of title arrangement (the obligation). Thus, even in those systems there is a 'décollage' between the law and the market reality.

RESTRICTIONS ON THE MANNER IN WHICH SECURITIES MAY BE HELD, I.E. WHICH ACCOUNT PROVIDERS MAY BE USED TO ACQUIRE RIGHTS THAT ARE PROTECTED UNDER THE DOMESTIC LAW.

In the Netherlands the legal rights of the account holder vary (and are characterised differently) according to the legal regime under which his securities are held.

This will depend on whether the securities (bearer or registered) are held through a custodian under the Dutch Giro Act - in which case the holder will be recognised as a co-owner in a collective deposit of securities - or whether they are bearer shares held outside of the Giro Act regime for example by a Dutch intermediary on behalf of foreign shareholder - or if they are held abroad.

Consequently the legal results are distorted depending on manner in which the securities are held: if they are held with an account provider that is not a participant in a recognised settlement system (such as Euroclear NL) so that they fall outside the terms of the Giro Act - or if they are registered directly with the issuer (i.e. as registered shareholders) - then the investor will have no rights against his account provider other than those agreed in the account agreement.

Similar restrictions exist in other MS (e.g. Belgium, Slovenia) where the investor's legal rights vis à vis the account provider depend on the account provider participating in a settlement system recognised by the domestic regime for dematerialised securities.

In most of the Nordic and C&EE regimes for book entered securities, disposals of securities must be registered at a central depository or registry, which is a public entity (e.g. Polish KDP, Finnish AKP, Czech Centre for Securities (SCP), Slovenian KDD, etc). If the disposal is not registered in the central registry (or an authorised sub-registry kept by a foreign custodian, for example), the legal effects of that book entry may not be recognized or the domestic law is unclear on that issue (a case in point is Estonia).

In the Nordic systems, which follow the direct ownership model, securities are by and large dematerialised. In such jurisdictions the legal status of securities in omnibus or nominee accounts or of those securities held with intermediaries outside of the book entry system is less certain (e.g. Finland).

The account holder has the right to have his dematerialised securities registered on a CSD owners account i.e. at the top tier (e.g. Sweden). Non CSD accounts are less regulated and are governed largely by custodian agreements.. The intermediated system based on co-ownership in a 'pool' does not normally give the account holder that right.

In some cases, eg Slovenia, the domestic law on dematerialised securities goes one step further and requires all end investor accounts to be maintained at the central registry.

There needs to be clarification in this area, so that the investor, who chooses to invest through his usual account provider when the latter is not participating in the settlement system that is privileged in domestic legislation, is not prejudiced in his rights.

CERTAIN MS HAVE DOMESTIC PRUDENTIAL INSPIRED RULES FOR SAFEGUARDING OF CUSTOMER ASSETS THAT RELATE ONLY TO DOMESTICALLY INCORPORATED ACCOUNT PROVIDERS REGARDLESS OF WHERE THEY ARE CARRYING ON SUCH SERVICES BUT NOT TO FOREIGN ACCOUNT PROVIDERS REGARDLESS OF WHERE THEY ARE CARRYING ON SUCH SERVICES.

CERTAIN MS LAWS HAVE NO RULES ON WHAT ACCOUNT HOLDER RIGHTS ARISE IN CASE FOREIGN ISSUED (BUT DOMESTICALLY LISTED) SECURITIES ARE HELD ON ACCOUNT WITH THE DOMESTICALLY RECOGNISED SSS

For example, Greek law in this area provides for the safeguarding of assets (held in book entry form) by Greek incorporated intermediaries regardless of where they are carrying out these services. However, **the Greek law does not provide for safeguarding of assets by non-Greek intermediaries regardless of where they are carrying out these services. The segregation principle is thus applied by law only to book entry assets (whether the investor has *in rem* or only beneficial rights in them) held by Greek intermediaries.**

Also, a non Greek issuer may want to register his securities in DSS or BGOS. There are no national rules on what rights account holders would get and how such rights would arise in such cases. Greek law does not foresee that foreign issued securities which are listed in Greece (on ATHEX) may be held in book entry form on accounts with the national settlement centre, DSS. Greek law on dematerialised securities only foresees DSS (or BGOS) registration of Greek issued securities.

There are thus also no Greek rules on how rights in such domestically registered but foreign issued securities arise.

There are no national rules on the registration of securities issued by Greek issuers but registered with a foreign CSD or custodian (i.e. not with DSS or BGOS).

In the Spanish law, only securities registered with IBERCLEAR or in a IBERCLEAR participant's account are considered valid for generating rights vis à vis the issuer, thus the manner of holding the rights i.e. in which intermediary's account, impacts on what rights you as account holder acquire.

Some MS like Lithuania limit the instruments that can be "transferred" and settled within the national SSS to wholly dematerialised instruments that are registered to the account holder's name.

Further, if they are not so registered, they only allow registration and transfer of ownership within nominee accounts that are managed by a foreign entity custodian. France allows 'nominee accounts' to operate within its dematerialised system only if they are managed by foreign account managers.

DISTINCTION MADE BY MS LAWS BETWEEN RIGHTS ARISING OUT OF SECURITIES AGAINST THE ISSUER AND THE RIGHTS IN RESPECT OF THE SECURITY

The member states are divided on this, some make a distinction between rights that can be exercised by the registered owner against the issuer and those rights which depend and may be modified by the custody or depositary agreement (e.g. France, Austria).

Others make no distinction in these rights once lawfully acquired and the ownership arising from the holding can be exercised also against the issuer (Poland, Portugal, Slovenia, Slovakia).

NATIONAL RULES RESTRICTING THE ABILITY OF THE ISSUER TO CHOOSE THE PLACE OF LOCATION OF SECURITIES FOR PURPOSES OF THE ISSUE (Q38 of JUMBO)

In some MS legal restrictions exist in this area. Here are a few examples.

Danish legislation prevents the issue abroad of dematerialised securities through a foreign CSD.

Czech Commercial Code provisions on issue of dematerialised securities state that issuers may only issue such securities in certificated form OR in accordance with the Capital Market Trading Act - which implies that the issue of such securities abroad is not permitted.

In Slovenia certain domestic issuers, e.g. banks, are required by law to issue dematerialised securities via the national depository (KDD) and it is thus not possible for them under Slovenian law to decide the place of location elsewhere.

In the UK and Eire share registers must by law be kept in the EUK and Eire respectively.

THERE IS NO UNIFORMITY IN MS LAWS REGARDING THE CORPORATE RIGHTS WHICH CAN BE EXERCISED BY INTERMEDIARIES ON BEHALF OF ACCOUNT HOLDERS. THE EXTENT OF THE OBLIGATIONS OF INTERMEDIARIES TO PASS DOWN CORPORATE INFORMATION VARIES DEPENDING ON WHERE THE ACCOUNT IS REGISTERED

Generally in the Nordic and Baltic direct ownership systems, the obligations of the intermediary vis a vis the issuer and the customer are based on a mandate from the registered owner, which is only a contractual right and can be withdrawn at any time.

In some cases this contractual arrangement is circumscribed by domestic legislation.

For example Finnish law does not allow intermediaries to exercise voting rights on behalf of account holders in their book entry system.

As a rule German custodian banks do not exercise voting rights in respect of foreign securities not listed in Germany.

In the Spanish book entry system only investors with an account with IBERCLEAR or with a participant in IBERCLEAR have a direct relationship with the issuer, with all that that implies for exercise of their corporate rights. Account providers fulfil a dual function, a contractual one and a public interest one as participants in the Spanish public securities holding system, which is a public register.

In some of the new MS (e.g. Hungary, Czech Rep., Slovak Rep., Poland) the capital market laws impose obligations on intermediaries of accounts registered at the top tier CSD to identify their customers or state if they are operating a nominee account as opposed to an individual account on behalf of customers. These identification obligations tend to be more stringent than in the other member states.

These differences reflect a more fundamental diversity in the tasks and functions accorded by MS laws to intermediaries and hence the legal status of the intermediaries providing account services.

Rules on good faith purchases and account provider lien over client assets

In this area there is a sheer diversity of MS laws. They range from MS with no special rules on good faith to those that give account providers a statutory lien over client assets and those that grant account providers no such special treatment and leave it to contract

A minimum level of harmonization is required.

Shortfalls

MS laws do not generally regulate what happens upon such event. In the individual accounts ownership systems, e.g. the case of the Nordic MS, shortfalls are not possible as the rules of such regimes make it possible to trace the ownership of the securities up all the tiers.

A minimum level of harmonization appears desirable, however.

VARIATIONS IN THE HOLDING STRUCTURES ACROSS MS

Are these variations per se an obstacle to an efficient, integrated post trading market? Markets in financial services are still largely national and this is reflected in MS legislation. Differences in MS laws are behind these structural variations. As a result the investor is uncertain about his legal position, especially in a cross border transaction. These legal differences represent additional expense and complication for investors that are forced to adapt to them if they want to invest in a given domestic market. They thus represent a significant legal barrier to a single market in intermediated securities.