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**Subject: EU Clearing and Settlement
Legal Certainty Group
Draft Advice of the Legal Certainty Group**

1. INTRODUCTION

[This will set out the background to the Group's work, and recall the three issues the mandate of the Group requires it to consider]

2. NATURE OF THE PROBLEMS

[This will state that the Group has resolved to endorse its views with reference to specific practical experiences, will survey the anecdotes provided, and will identify the 3 legal perspectives from which there is said to be no such experience.]

3. NATURE OF THE SOLUTION

The debates of the Group have been dominated by discussions as to how Community law should move forward in this field. In particular, should it lay down *minimum rules* for the rights that arise upon a book entry in favour of an account holder, or should those rules be established as a packaged, fully articulated bundle of rights, a kind of *legal asset*, indeed what would be in all but a couple of Member States a new legal asset?

The Group decided that, at this stage in the evolution of the EU's markets, only the former is needed. It acknowledged, however, the power of the arguments in favour of the latter, and decided briefly to describe how that concept would work, in case the idea is to be taken up in the future.

That exposition is set out in the rest of this section.

4. GROUP MANDATE ISSUE 1 - NEW LEGISLATION ABOUT RIGHTS THAT ARISE UPON A BOOK ENTRY IN FAVOUR OF AN ACCOUNT HOLDER

As to the absence of an EU-wide framework for the treatment of interests in securities held with an intermediary, the Legal Certainty Group ("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.

If the advice set out here is found to be attractive, it will be necessary in the future to give definitions to a number of key terms. In this advice, terms are used generically. In particular, all entities in a chain of holdings are 'account providers', except the ultimate investor. And all entities are 'account holders', except the issuer and any operator of an account by which securities are established in book entry form (typically a CSD).

4.1. Core propositions

The new legislation is based on the following propositions:

- 4.1.1. Book entries on securities accounts are a source of rights for the account holder.
- 4.1.2. Nothing in the new legislation prohibits or impedes any market practice for holding securities, such as direct holding by the account holder with the issuer, both with and without account providers at the intermediary level, holding securities in a pool, or holding through individually segregated accounts.
- 4.1.3. The new legislation does not replace existing national laws of property, unless such laws are inconsistent, in which case they will need to be conformed.

4.2. Legal effects of book entries

The rights that arise upon a book entry in favour of an account holder are:

- 4.2.1. to instruct the account provider to make a book entry on the account for such purpose as to dispose of the rights in favour of a purchaser, or other recipient, to pledge or otherwise charge the rights, to limit the rights in any other way, to change the account on which the rights in the security are held, including by changing to a different account provider;
- 4.2.2. to retrieve the securities to which the rights relate by delivery of a certificate or any other means, to the extent provided for under the terms of the issue and the law applicable to the issue;
- 4.2.3. to instruct the account provider, whether specifically or by general instruction, to facilitate such rights as the account holder has in respect of the securities to which the book entries relate, such as the right to vote, to receive dividends, interest, income, capital, to subscribe for further securities, the opportunity to consider takeover offers and any other corporate event;
- 4.2.4. to receive corporate information communicated to the account provider in that capacity and relevant for the exercise of voting rights or other corporate rights.

To ensure that the rights that arise upon a book entry in favour of an account holder are sufficiently robust, they must be supported by a minimum number of protective rules. These rules are set out in sections 4.3 to 4.8 below.

4.3. Rules on Priorities

The rights that arise upon a book entry in favour of an account holder have priority over any right, interest or claim of a creditor or third party, except where such interest or claim arises by mandatory operation of law or where all parties have so agreed.

4.4. Bona fide

A person who has a book entry made in his favour, may rely on that book entry against the account provider and against any third party unless he knew that the book entry should not have been made.

4.5. Prohibition of upper tier attachment

The rights that arise upon a book entry in favour of an account holder may be asserted only against the immediate account provider, and in consequence may not be enforced nor is attachment allowed against any upper-tier account provider.

4.6. Account provider insolvency.

The insolvency of an account provider shall not affect the rights that arise upon a book entry in favour of an account holder and the rights that arise upon a book entry in favour of an account holder do not form part of the insolvent account provider's estate.

A rule will be needed within the new legislation as to how the insufficient assets are shared among account holders, if there is an incurable shortfall on the account. The formulation of this rule is a matter for policy-makers.

4.7. Rule on validity of credit entries

The rights that arise upon a book entry in favour of an account holder will not arise in the event that the book entry is invalid. Rules will be needed within the new legislation as to the circumstances under which a book entry is liable to be invalidated, and whether the invalidity should be as from the moment the book entry was made, or only as from a later moment. The maximum period of time during which a book entry may be invalidated may be left to contract.

4.8. Option to prohibit conditional settlement

Member States may require that account providers, before making any book entry in favour of an account holder, have aggregate holdings designated as holdings for account holders that are at least equal to the aggregate book entries in favour of their account holders or, where individual accounts are used, have sufficient coverage at the upper tier for the specific account holder. Where Member States do not so require, and thus allow 'uncovered' or 'conditional' settlement, this fact must be made clear to account holders, so as to provide transparency across the single market.

4.9. Duties of the account provider

- 4.9.1. to maintain total assets matching the balance of credits on its account holder's accounts;
- 4.9.2. to pass down to the account holder corporate information that is communicated to him in that capacity and relevant for the exercise of voting rights or other corporate rights;
- 4.9.3. to pass up the chain of account providers the information and instructions of the account holder in exercise of his rights;
- 4.9.4. to follow the account holder's instructions (specific or under the terms of an agreement between the account holder and his account provider);
- 4.9.5. to segregate his own assets from that of his account holders in such a way as to effectively safeguard client assets in event of his insolvency (as required by article 13(7) of MIFID);
- 4.9.6. if there are insufficient assets at the upper tier to cover the assets held on his account holder's account, to replace the missing assets from the market, failing which to replace the missing assets from the account provider's own assets (if it has any), failing which to supply other securities of equal value; failing which to reimburse the value of the securities.

4.10. Other rights

The rights that arise upon a book entry in favour of an account holder do not affect any other rights of the account holder in respect of the securities (e.g. right to compensatory damages) such as arise by operation of law, under the account agreement or under the terms of issue, provided the latter do not conflict with the rights that arise upon a book entry in favour of an account holder.

4.11. Subject to the account agreement

The rights that arise upon a book entry in favour of an account holder described in 2.1.1, 2.1.2 and the duty described at 2.8.1 are inalienable and immutable.

Whether the same should be said of the rights that arise upon a book entry in favour of an account holder described in 2.1.3 and 2.1.4 and the duties described at 2.8.2 and 2.8.3 remains to be decided when the final detail of the proposed Directive on cross-border shareholders' voting rights has been examined.

All the other rights and duties may be modified or disappplied by agreement between the account provider and account holder.

5. EXPLANATORY NOTES FOR THE NEW LEGISLATION

5.1. The rights that arise upon a book entry in favour of an account holder

An account holder is a holder of the rights that arise upon a book entry in favour of an account holder. All rights contained within the rights that arise upon a book entry in favour of an account holder arise upon a credit entry to an account (provided the entry is valid and enforceable). The account holder becomes entitled to the rights that arise upon a book entry in favour of an account holder 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 appearance of credits on an account represents the creation of the rights that arise upon a book entry in favour of an account holder. Thus, a debit entry in one securities account and a credit entry in a different securities account causes the rights that arise upon a book entry in favour of an account holder to disappear and appear in a slightly different form. The rights that arise upon a book entry in favour of an account holder are constituted and de-constituted by respectively crediting and debiting accounts, i.e., they do not multiply upon each credit entry, and they 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 that arise upon a book entry in favour of an account holder are conferred.

5.2. Scope

5.2.1. Securities

The new legislation should apply to securities and rights in securities, with the wide meaning attributed to that concept by Community law (MiFID, for example), to the

extent they have been established in book-entry form. 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.

5.2.2. *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).

Special rules will be needed to exclude business situations that are not intended to constitute intermediary relationships, for example where the holding of assets is concentrated within a group of companies in one member of the group. It must also be noted that in some cases the account holder/account provider relationship is not established by contract.

5.2.3. *Account holders*

Any account holder, wherever he is located in the tier of holdings.

5.2.4. *Domestic and cross-border*

All credits are covered, whether or not they relate to a transaction with a cross-border element, and at whatever level of the chain of holdings they are made. It is in any event practically impossible to restrict the application of the new legislation to cross-border trades only.

5.2.5. *Cash leg*

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

5.2.6. *Terms of issue*

The terms and conditions of securities as issued are to be unaffected. Transitional provisions will be needed to cater for existing securities the terms of which pre-suppose a particular substantive law regime, if any are found to exist.

5.2.7. *Company law*

For current purposes, the advice is subject to the proposed Directive on cross-border shareholders' voting rights, especially paragraphs 2.1.3, 2.1.4. and the duties described at 2.8.2 and 2.8.3.

5.2.8. *CSDs*

The new legislation should apply to all accounts that intermediate between the issuer and the holder of securities or rights in securities. This would therefore encompass CSDs.

However, the new legislation should not apply to accounts the sole purpose of which is to establish securities in book-entry form (sometimes referred to as 'issue accounts').

5.3. 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. The approach taken in this advice is to leave these matters to policy-makers.

5.4. 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.

6. GROUP MANDATE ISSUE 2 - DIFFERENCES IN NATIONAL LEGAL PROVISIONS AFFECTING CORPORATE ACTION PROCESSING

The Group considers that differences in national legal provisions affecting corporate action processing, such as discrepancies in Member States' laws as to the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g., for the payment of dividends, will be addressed at least in part by the solution advised for the first issue within its mandate. To the extent that it is not, the Group feels that the matter should be addressed when the final shape of the Commission's proposed directive on cross-border shareholders' rights is known.

7. GROUP MANDATE ISSUE 3 - RESTRICTIONS RELATING TO THE ISSUER'S ABILITY TO CHOOSE THE LOCATION OF ITS SECURITIES.

Restrictions relating to the issuer's ability to choose the location of its securities do indeed exist and can be removed only by legislation.