



**EUROPEAN COMMISSION**

Internal Market and Services DG

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

Brussels, 22 February 2007  
PP D(2007)

**LCG-2**

**LEGAL CERTAINTY GROUP  
2007/2008 ADVICE  
SUBJECT 1 ("BOOK-ENTRY")**

**INTRODUCTION/METHODOLOGY SUBJECT 1**

**PRELIMINARY DISCUSSION DRAFT**

*Observations by Lars Afrell, Olaf Christmann, Klaus Löber, Ulrik R. Bang-Pedersen and Martin Thomas are reflected in this version. Where useful, these observations are identified separately.*

**1. IDENTIFICATION OF THE EXACT SCOPE OF WORK**

**1.1. Mandate**

**In January 2005, the Commission, with respect to Subject 1 ("book-entry") mandated the Legal Certainty Group to:**

- undertake in-depth legal analysis regarding “the absence of a EU-wide framework for the treatment of interests in securities held with an intermediary”,
- make a proposal regarding a solution to such problems of legal uncertainty as have been confirmed by the analysis, and
- provide informal assistance by advising the Commission of specific technical issues.

**1.2. Advice 2006**

On the basis of this mandate, after five meetings held in Brussels, on 28 July 2006, the Legal Certainty Group submitted its Advice to the Commission (hereinafter: "2006 Advice"). According to the July 2006 Advice, there is a need for future EU legislation which should deal with the following issues (for details *cf.* 2006 Advice, p. 5-7):

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- Legal effects of book entries, including rules on priorities and *bona fide* acquisition;
- Prohibition of upper-tier attachment;
- Protection of the account holder against insolvency of its account provider;
- Rules on “validity” of book entries and so called conditional credits;
- Duties of the account provider;

Furthermore, the Advice set out several basic principles:

- Nothing in the new legislation should determine markets practice for holding of securities;
- Existing national property or company law concerning securities should not be replaced, however, they would need to be conformed in case the conflicted with the basic aims of the new legislation;
- Several elements belonging to the above mentioned issues cannot be altered by contract (account agreement), whereas this is possible with respect to other elements;

### **1.3. Follow up work**

Upon receipt of the 2006 Advice, the Commission invited the Legal Certainty Group

- to give further advice, in elaborating on the 2006 Advice, by describing exactly the provisions that would be needed in legislation dealing with the legal effects of book entries made to securities accounts;
- to identify at an early stage the issues that are best decided by policy makers, so that suggestions on these issues could be made to the Group during its work progress;
- to closely monitor the work of UNIDROIT and to inform the Commission whether the UNIDROIT draft text matches the new legislation described in the Advice.

## **2. ELEMENTS TO BE KEPT IN MIND WHILE ELABORATING ON THESE ISSUES**

In the following, some important aspects that ought to be kept in mind while elaborating on the 2006 Advice are set out. As there is not necessarily a logical link between them they don't follow any specific order:

### **2.1. Purpose and form of the future Advice**

The main task is "describing exactly the provisions that would be needed in legislation dealing with the legal effects of book entries made to securities accounts". Consequently, building on the 2006 Advice, legal analysis and conclusions from this analysis will be refined in the future. The result should

provide the Commission with a very detailed picture of the opinion of the Group regarding the answers which should be provided by the EU legal framework with respect to holding and transfer of securities via book entries. To this end it is not absolutely necessary to draft a set of legal provisions: it is more important that their necessary content is described crystal clear and that alternative solutions are explained and weighted. If the Group were in a position to have sufficient time to draft legal provisions, this might be helpful to illustrate the Groups thinking on the best possible solution.

*Observation by Martin Thomas: the Group could immediately start preparing a hypothetical draft of EU legislation.*

## **2.2. Interaction with other EU initiatives**

There are several pre-existing and future EU measures which deal with closely related issues. The LCG should give regard to the following issues:

### **2.2.1. *Ensure compatibility***

Clear identification of other EU measures (legislative and non-legislative, maybe including also private initiatives like the Code of Conduct) is essential in order to avoid overlap, frictions or incompatibilities. For example: the MiFID level 1 and level 2 measures provides for rules on segregation; equally, the 2006 Advice calls for a duty of account providers to segregate own from clients' assets to be included in the future legislation. Furthermore, the LCG will have to pay attention to pre-existing concepts and defined terms in other EU-measures. They should be assessed and tested in the context of the scope of the work of the LCG. In case of incompatibility, the LCG should indicate a solution (alternatives including the amendment of the other definition).

### **2.2.2. *Potential to merge***

It might turn out to be useful to propose a merger of the future legislation on the legal effect of book entries with pre-existing EU-measures. This could be in particular the case where issues within the scope of the LCG are partly addressed by existing legislation or are addressed with respect to a restricted personal scope. Options include proposing new legislative measures which include parts of pre-existing legislation or proposing pre-existing measures to be developed further so as to comprise the scope of the work of the LCG.

## **2.3. Constant scrutiny**

This field of law is quickly evolving, and discussions are going on in several fora (LCG; other EU-groups; Commission, market initiatives, UNIDROIT; third countries). New developments will need to be taken into account and the premises of the 2006 Advice should be under constant scrutiny when developing a more detailed new Advice.

This relates also to the completeness of the scope of this exercise: discussion have revealed that rules on the legal effect of book-entries would not have their

full effect unless they take into account additional elements which are interconnected and cannot be addressed separately, such as: (a) legal position of the account holder; (b) priorities/good faith acquisition; (c) “validity”, reversal, effectiveness *inter partes* and *erga omnes*. Against this background it is crucial that, during the future work, regard is given to this point in order to avoid any gaps in any future legislation.

#### **2.4. Internal market: going beyond minimum standards**

The 2006 Advice sets out the scope of future EU legislation. However, whereas in many areas no decision has been taken regarding the level of the necessary or desired integration, i.e. how far harmonisation must go in order to achieve the aims as set out in the original EU reports (2005 Communication and Giovannini Reports).

Many commentators regard the degree of harmonisation achieved to date by the UNIDROIT draft as absolute minimum, its main feature being the elimination of the "domino effect" of defective transactions by ensuring basic interoperability and therefore the reduction of threat to the stability of the financial system which is caused by differences of the national legal regimes applicable to book-entry securities. Harmonisation within the EU should achieve at least the same minimum basic effect with respect to an equally broad personal scope (covering basically all intermediaries and account holders).

As a next step in this regard the LCG might identify issues where the future EU legislation should go beyond the absolute minimum. The UNIDROIT draft mentions issues that are closely linked with the substance but are however left out as harmonisation on a global level appeared too ambitious.

*Observation by Klaus Löber and Ulrik R. Bang-Pedersen: The LCG could use these issues as an indicator and should commence an assessment whether harmonisation of these issues in the context of the EU is desirable or necessary.*

*Observation by Klaus Löber: to the extent that an EU solution might necessitate more detailed or additional provisions, they the following points could be emphasised:*

- details for rules ensuring the integrity and stability of holding systems*
- enhanced investor protection*
- duties of the intermediary (in particular with a view to the "Code of Conduct")*
- perhaps corporate action issues.*

#### **2.5. Relationship with the UNIDROIT draft**

The UNIDROIT draft Convention on Intermediated Securities covers basically the same scope as Subject 1 of the Legal Certainty Project and is currently developed by 36 countries, amongst them nearly all EU countries, the US, Switzerland and Japan. At an early stage of this second phase of the LCG work, a technique should be developed on how the UNIDROIT draft could be made usable for the purposes of future EU legislation. There are, according to the mandate of this group, probably three points of contact between the LCG Advice and Unidroit which need to be dealt with separately:

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- The Unidroit draft can be a source of inspiration for issues that might be worth considering for a deeper EU harmonisation;
- The monitoring exercise of this Group aims at ensuring compatibility between both the future EU legislation (based on the LCG advice) and the future Unidroit Convention. This means that future EU legislation would fit into the framework set by Unidroit in the sense that it would enable Member States and the EU to adhere to the future Unidroit Convention.
- The future 2007 Advice of this Group will have an important impact on the EU's and the Member States' attitude towards the UNIDROIT draft. However, the LCG has no formal role with respect to negotiating UNIDROIT. The Member States consult with the Commission on common positions in this respect in a separate forum.

### **2.6. Issues of policy choice**

The Group will probably identify several issues as linked to the substance and within the scope of its mandate which it cannot deal with, in particular because any going further involved a choice of policy. Under the mandate given by the Commission, such issues should be notified to the Commission at an early stage of the work, probably by the end of 2007. However, when asking guidance from policy makers, the LCG should present the various options that are available and what the overall impact of the choice would be.

### **2.7. Research etc.**

In order to maintain the high level of quality of the working method and the output of the LCG, it will be necessary to build on the results of earlier research (amongst other things, the "Compendium of answers"). Additional research projects might be initiated during the course of this year.

## **3. TIMING**

- 2007: Development of further LCG advice; ongoing work of the UNIDROIT CGE on Intermediated Securities
- End of 2007: LCG proposal to the Commission (a) conclusion on basic level of harmonisation; (b) firm opinion on further harmonisation; (c) highlight areas where political guidance is needed regarding harmonisation beyond basic level; (d) presentation of the "interim" 2007 Advice
- Spring 2008: UNIDROIT Diplomatic Conference – Signature.  
N.B. The Diplomatic Conference is where the final text is endorsed which cannot be altered later.
- 2008: developing further the Advice on the basis of interim report and the outcome of Unidroit, taking into consideration political guidance sought from the Commission
- Late 2008: presentation of the 2008 Advice, end of the work of the LCG.

**4. STRUCTURE FOR FUTURE WORK ON SUBJECT 1 AND THE 2007/2008 ADVICE:**

- Chapter 1: Introduction/Methodology [the present draft paper]
- Chapter 2: Principles for a new EU legislation on the legal effect of book entries; incl. scope of application and definitions [basis: 2006 Advice]
- Appendices: Set of hypothetical draft legal provisions [to be done at a later stage]
- Assessment of interaction with other EU initiatives [to be done]
- Monitoring report on the UNIDROIT preliminary draft Convention [first draft available]
- Comparative Analysis etc. [earlier version available on website, to be revised, new analysis added in course of 2007]
- etc.

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