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

**PRINCIPLES FOR NEW LEGISLATION ABOUT THE LEGAL EFFECTS OF BOOK ENTRIES**

**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.*

[Basis of this text is the 2006 Advice (Chapters 5&6)]

The core principles of the new legislation are set out in this advice, which describes the new legislation, but 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. At this stage, terms are used generically. In particular, all entities in a chain of holdings are 'account providers', except the last account holder, often referred to as the ultimate investor. And all entities are also 'account holders', except the issuer and any operator (typically a CSD) of an account (typically an 'issue account') by which securities are entered in a book entry system.

Throughout the advice, the expression "book-entry rights" is used. This is intended to be a portmanteau expression, covering legal concepts that view the rights related to a book entry being made in favour of an account holder as being transferred by the book-entry, legal concepts that view the rights as arising by virtue of the book-entry, and any variations of those concepts, all as found within the EU. The expression "book-entry rights" is thus neutral between the range of legal approaches within the EU, and is not intended to favour any one of them. It should also be stressed that "book-entry rights" is used in this advice purely as a shorthand label, and is not, and should not be taken as, indicating that the rights that are transferred, are effected, arise and so forth are being given a name in the legal sense.

## 1. CORE PROPOSITIONS

The new legislation should be based on the following general propositions:

- 1.1. Book entries on securities accounts are a source of rights for the account holder.
- 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.
- 1.3. The new legislation does not replace existing national property laws concerning securities, nor where relevant company law; however, if such laws are incompatible with the aim of the new legislation, which is to recognise the legal effects of a book-entry, they will need to be conformed.

*Observation by Klaus Löber: this principle could be specified further, in particular as regards the methodology applied to identified/necessary modifications of national laws – for instance whether a minimal intrusive approach was pursued.*

## 2. LEGAL EFFECTS OF BOOK ENTRIES

### 2.1. Book-entry rights are:

- 2.1.1. 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 terminating the account with the account provider;

*Observation by Klaus Löber: the wording differed and might be less strong than in the Unidroit draft, where emphasis was given to the right to instruct rather than to the effect (to cause a transfer or a security interest).*

- 2.1.2. to retrieve, or instruct the account provider to facilitate the retrieval of, 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, the law applicable to the issue, and the law applicable to the account provider;

- 2.1.3. to instruct the account provider, whether specifically or by general instruction, to facilitate the exercise of 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;

*Observation by Klaus Löber: (a) the advice is silent on the acquisition of corporate rights – rightly so? (b) this paragraph is formulated as an absolute obligation of the intermediary – rightly so?*

- 2.1.4. to receive from the account provider corporate information communicated to the account provider in that capacity and relevant for the exercise of voting rights or other corporate rights.

*Observation by Klaus Löber: this is formulated as an absolute obligation – rightly so?*

- 2.2. The account holder becomes entitled to book-entry rights as of the moment at 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.

-- To ensure that book-entry rights are sufficiently robust, they must be supported by a minimum number of protective rules. The general principles of these rules are set out in sections 5.3 to 5.8 below.

### 2.3. Rules on Priorities

Book-entry rights have priority over any right, interest or claim of a third party, such as a creditor of the account provider, except where such right, interest or claim arises by mandatory operation of law or where the parties have so agreed.

*Observation by Klaus Löber: the LCG might consider to developing a full picture regarding priorities, in particular taking into account mechanisms that do not require book-entries (in particular: control agreements). A clear position is needed whether to open up to other alternative mechanisms.*

## **2.4. Bona fide**

An account holder 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 or ought to have known that the book entry should not have been made. A rule will be needed within the new legislation specifying how this test is to be applied.

## **2.5. Prohibition of upper tier attachment**

Book-entry rights may be asserted only against the immediate account provider, and in consequence may not be enforced, nor is attachment in respect of such rights, allowed against any upper-tier account provider.

## **2.6. Account provider insolvency**

The insolvency of the account holder's immediate account provider shall not affect book-entry rights and book-entry rights (and corresponding book-entry rights held by the account provider with another account provider) do not form part of the insolvent account provider's estate.

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

*Observation by Klaus Löber: the 2007 Advice should highlight all possible solutions and explain advantages and disadvantages. It should also take into account particular arrangements that could affect the reasoning behind such rule, as for example customer assets that are segregated even at the upper level of the holding chain (probably, they should not form part of the basis of the loss sharing).*

## **2.7. Rule on validity of credit entries**

A credit on a securities account constitutes evidence of the book-entry rights of the account holder.

*Observation by Klaus Löber: the subject of this paragraph should be moved to either "core propositions" or "legal effects" (above). It is not entirely clear whether it contradicts paragraph 1.1.*

Book-entry rights will not arise if 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, and whether the invalidity should be addressed by the making of fresh reverse entry or by treating the initial book entry as legally void.

The maximum period of time during which a book entry may be invalidated is a matter for policy-makers to decide.

*Observation by Klaus Löber: the 2007 Advice should make clear whether issues of validity extend to both credit and debit entries or just to credit entries. This principle needs to be refined considerably given the great importance of the rules on effectiveness, validity, conditional credits and reversal; the Unidroit text could serve as a starting point.*

## **2.8. Option to prohibit conditional settlement**

Member States may require that account providers, before making a book entry in respect of particular securities in favour of an account holder, have aggregate holdings

[PRELIMINARY DISCUSSION DRAFT]

designated as holdings for account holders that are at least equal to the aggregate book entries in respect of such securities in favour of their account holders (including the book entry to be made) 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.

## **2.9. Duties of the account provider**

In order to preserve book-entry rights, the duties of the account provider must be at least as follows:

- 2.9.1. to maintain holdings matching the balance of credits on its account holder's accounts;
- 2.9.2. to pass down to the account holder corporate information that is communicated to it in that capacity and relevant for the exercise of voting rights or other corporate rights;
- 2.9.3. to pass up the chain of account providers the information and instructions of the account holder in exercise of his rights;
- 2.9.4. to follow the account holder's instructions in relation to the account (specific or under the terms of an agreement between the account holder and his account provider);
- 2.9.5. to segregate own securities from that of its account holders in such a way as effectively to safeguard clients' securities in event of its own insolvency (similar to what is required by article 13(7) of MIFID for some account providers);
- 2.9.6. if there are insufficient assets at the upper tier to cover the rights of its account holders, and subject to contractual agreement and applicable rules on limitation and exclusion of liability, to replace the missing assets, failing which to reimburse the value of the assets.

## **2.10. Other rights**

Book-entry rights do not affect any other rights of the account holder such as arise by operation of law, or under the account agreement, or under the terms of issue, provided they do not conflict with book-entry rights .

## **2.11. Subject to the account agreement**

The elements of book-entry rights described in 2.1.1 and 2.1.2 and the duty described at 9.1 cannot be altered by contract. Note that the extent of liability for breach of that duty is dealt with at 5.9.6.

Whether the same should be said of the elements of book-entry rights described in 2.1.3 and 2.1.4 and the duties described at 2.9.2 and 2.9.3 remains to be decided when the final detail of the proposal for a directive on the exercise of shareholders' voting rights has been examined.

All the other rights and duties may be modified or disapplied by agreement between the account provider and account holder. In particular, the duties at 2.9.6 may be agreed to arise only where the account provider is at fault .

### **3. NOTES FOR THE NEW LEGISLATION**

#### **3.1. Book-entry rights**

The new legislation does not aim at any reconstruction or fundamental change to national ownership concepts, which should be preserved.

The legal effects of a book entry in favour of an account holder arise upon a credit entry to the account (provided the entry is valid). The account holder becomes entitled to the rights as of the moment on which the credit entry is made by the account provider on the account holder's account and ceases to be entitled to them upon a debit entry being made.

Note, however, that the rights that are required to arise are a minimum: in many cases, Member States laws can and will confer further rights. Indeed, in many cases book-entry rights already exist at the national level. For some Member States, the new element will be the attribution of legal effects to entries made on securities accounts, such that the new legislation will create new rights against the account provider. For other Member States, the new legislation will emphasize already existing legal effects against the account provider.

The new legislation cannot and does not seek to change the rights contained in securities, but rather - in some instances - the way these rights are administered, exercised or enforced.

In all cases, book-entry rights are un-classified, un-characterised and doctrinally-neutral at the harmonising EU level. They neither replace nor alter national property rules concerning securities.

#### **3.2. Scope**

##### **3.2.1. Securities**

The new legislation relates to securities, including rights in securities (as long as they are not merely contractual claims), with the wide meaning attributed to that concept by Community law (MiFID, for example). 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 should 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 act commercially as 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; this may, for example, arise in the context of certain inter-group relationships. It must also be noted that in some cases the account holder/account provider relationship is not established by contract.

### 3.2.3. CSDs

The new legislation should apply to all accounts that intermediate between an issuer and investor. This would therefore encompass CSDs when acting in their capacity as account providers. However, the new legislation should not apply to accounts the sole purpose of which is to enter securities in a book-entry system (sometimes referred to as 'issue accounts').

The new legislation is intended to be compatible with the rules of CSDs. It will of course be necessary to investigate whether any CSD-specific exceptions may be merited (for example, to enable DvP), when and if the detail of new legislation has been mapped out.

### 3.2.4. Account holders

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

### 3.2.5. Domestic and cross-border

All book-entries on securities accounts 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.

### 3.2.6. Cash leg

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

### 3.2.7. Terms of issue

The terms and conditions of securities as issued are to be unaffected. Transitional provisions may be needed to cater for existing securities the terms of which pre-suppose any substantive law rules which are inconsistent with the new legislation (if any are found to exist).

### 3.2.8. Company law

For current purposes, the advice is subject to the proposal for a directive on the exercise of shareholders' voting rights, especially paragraphs 2.1.3, 2.1.4. and the duties described at 2.9.2 and 2.9.3.

## **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

[PRELIMINARY DISCUSSION DRAFT]

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 substantive law 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.

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