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LCG-11

**Subject: EU Clearing and Settlement
Legal Certainty Group
7th meeting: 7 May 2007
MINUTES**

1. The meeting was chaired by Mr Konstantinos Tomaras, European Commission. Attendees are set out in Appendix 1.

Welcome (No. 1 on the agenda)

2. The Chairman welcomed two new Members of the Group, Mr Martin Draslar (Czech Republic), and Mr Balász Sahin-Tóth (Hungary). He introduced Mr Philippe Dupont (Luxemburg) as the new co-ordinator of Subject 1 (“book entry”).

Adoption of the agenda (No. 2 on the agenda)

3. The aims of this meeting were defined as (a) complete discussions on the scope of Subject 1, (b) receive an update on and give guidance regarding the work of Subgroup 2 and 3, (c) build a first opinion within the LCG on whether and to what extent there would be interaction between the ESCB Target2-Securities project (“T2S”) and the future Advice of the LCG, and (d) monitor the Unidroit draft Convention in the sense that the Commission asked the LCG to give input for the negotiations where it deemed appropriate.

4. The agenda as proposed by the Secretariat was adopted with the following changes: (a) future work would be discussed directly in the context of each subject; (b) there was no need for establishing a specific list on points of contact with the Unidroit draft Convention. The amended draft agenda is reproduced as Appendix 2 to this report.

**Target2-Securities and its potential interaction with the work of the LCG
(No. 3 on the agenda)**

5. The Chair reminded that T2S was work in progress and that the LCG would have to pay close attention to it at various stages of its work. Klaus Löber (ECB) presented the project as set out in Appendix 3. The LCG discussed a potential overlap between its own work and the concept of T2S.

6. First, some Members identified an overlap as regards the aim of cost saving. Others admitted that there might well be a similar positive effect on cost of post-trading activities. However, for the following reasons, this was not a true "overlap": (a) T2S-related cost savings were based on the effect of scale economies within the process of settlement, whereas enhanced legal certainty would decrease the cost for credit and partly eliminate the necessity of additional case-by-case legal documentation; (b) cost saving was not among the primary aims of the work of the LCG but rather a side effect; (c) the scope of both projects was not identical ("Euro-countries" on the one hand, all EU Member States on the other hand). Therefore, it was unlikely that T2S could remove the main impetus for the LCG.

7. As a second issue, the LCG discussed whether T2S would have influence on the legal make-up of post-trading activities, in particular whether it would have impact on the law applicable between participants and governing the settlement. There was broad sense that T2S as a technical tool would rather not have such influence, as it was exclusively about outsourcing of certain functions. Legal qualification for both the customer relationship and the maintenance of the securities accounts would be unaffected by T2S. Finality and transfer would occur on the same legal basis as they did at present.

8. There was equally agreement that T2S was work in progress and that it was difficult to assess at this stage whether and to what extent there was an overlap with the work of the LCG regarding *legal* aspects.

Subject 1 - "book-entry" (No. 4 on the agenda)

State of play (No. 4a on the agenda)

9. On a general note, the LCG discussed the relationship between its own work and the work of Unidroit. There was the general feeling that Unidroit provided an excellent basis but that harmonisation within the EU was not bound to stop at this level (*cf.* the discussion on investor protection and systemic stability and other points raised in document LCG-6, *infra*). The current task of the LCG was to check whether there were gaps in its own blueprint for harmonisation and whether these gaps would be filled with measures that were compatible or not with the Unidroit draft. The future Unidroit Convention, as instrument of international public law, would rank above the EU harmonised legal framework, therefore both projects could not be entirely disconnected and conflicts should be avoided to the greatest possible extent. However, the LCG had to identify such potential conflicts, and policy makers then had to decide in which way these conflicts ought to be resolved. Others referred to the principle of subsidiarity: the fact that there were gaps within the LCG Advice compared to the Unidroit draft did not necessarily mean that harmonisation on a European level was actually necessary or useful; instead, some issues should probably be addressed by national legislation.

Consideration of Document LCG-7 (No. 4b on the agenda)

10. Discussions concentrated on the second monitoring question (pp. 3 *et seq.*)

11. Articles 5(1)(b) and 7(2) of the Unidroit draft ("Right effective against third parties") – the LCG agreed that this was already implicit in the *2006 Advice* but should be stated in a more precise manner.

12. Article 7(4) of the Unidroit draft ("Acquisition and disposition of security interests and other limited interests by credit and debit") – one view was that no position needed to be taken, as the subject was already covered by the Financial Collateral Directive (FCD). Others thought that this was exactly an issue where the LCG could go beyond the minimum standard of harmonisation and could propose to extend the scope of the FCD and harmonise further, though it was unclear how far the LCG mandate reached into advising on matters currently covered by the FCD. As regards limited interests other than security interests (e.g. usufruct), there was the feeling that these interests could in no case be harmonised in substance and that there needed to be just a rule regarding the relationship between other limited interest and security interests, in particular as regards priorities. Others added that a statement regarding security interests over entire securities accounts would be needed in the Advice.

13. Article 7(5) of the Unidroit draft ("Debits and credits on a net basis") – it was pointed out that a clarification stating that net settlement was a *possibility* was certainly useful – but this would be only for purposes of clarification; the real question was whether the LCG should venture into the area of harmonising the mechanisms of net settlement. This was doubted. The netting issue should not be addressed in terms of legal effect of book entries, as other issues which had no direct relation with these legal effects (e.g. reporting) were of higher significance in this area. Moreover, there was agreement that allowing net settlement was generally not an issue within the EU and therefore it was unnecessary to address it in the work of the LCG. Additionally, it was made clear that there can be netting on various grounds (CCP, for example) prior to the credit but that this was outside the scope of the work of the LCG. The discussion resulted in the decision not to address the issue.

14. Article 8 of the Unidroit draft ("Methods of creating security interests") – The general feeling was, as expressed *supra*, that the LCG should not get into the field of limited interests and that methods of providing collateral were rather an issue to be dealt with within the framework of the revision of the FCD. However, it was agreed to explore to what extent and within what timeframe the Advice of the LCG on matters covered by the FCD was sought. Others pointed out that Article 8 of the Unidroit draft was not just about creating collateral, but also about acquisition of an interest in securities (which was not covered by the FCD) and that this might be an interesting field for the LCG to explore. Another opinion was that, given the minor practical importance of limited interests in relation to security interests, there were two possible ways of handling the issue of limited interests without distracting the attention of the LCG too much: (i) either to drop the issue altogether, or, (ii) to deal with it by making simple reference, as regards evidential requirements, to the rules applying to security interests (particularly as there was, from a civil law perspective, no difference between what is treated as “security interests” and “other limited interests”). It was reiterated that it might be necessary at least to give limited interests some importance in the context of priority. Additionally, it was stressed that the choice given by Article 8 of the Unidroit draft could not be limited within the European context.

15. In the context of credit and debit, the question was raised whether the concept of book-entry as used in the *2006 Advice* was perfectly compatible with the concept promoted by Unidroit draft Articles 7-13. More precisely, the making of a designating entry or “earmarking” of securities appeared amongst the methods of Unidroit draft Article 8 and was therefore of an “inferior quality” than rights created by credit under Unidroit draft Article 7. It needed to be discussed within the LCG whether the future Advice should give the same or a different status to both methods, as under the current regime a designating entry was regarded as “credit”.

16. Article 9 of the Unidroit draft ("Other, *non-harmonised*, methods") – there was agreement that the priority issue which flew from the parallelism between harmonised and non-harmonised methods needed to be included in the future work of the LCG. Regard had to be given to the fact that, under Unidroit, not only the credit was afforded priority but also other methods (designating entry, control agreement).

17. Article 13(4) of the Unidroit draft ("Loss of priority by intermediary") – this issue was identified as being worth considering for inclusion in the future Advice, though the work regarding revision of the FCD might be a better place to address the issue. Consequently, in the first place, it should be channelled to the relevant working body dealing with the FCD.

18. Article 18 ("Instructions to the intermediary") – the LCG was of the opinion that this important issue was already implicit in the *2006 Advice* and needed to be highlighted in the future work.

19. Article 19 of the Unidroit draft ("Requirement to hold sufficient securities etc.") – the LCG considered sections 5.9.1 and 5.9.6 of the *2006 Advice*, following which the obligation to hold sufficient securities was an absolute one and the obligation to buy in missing securities could be altered by contract. Some expressed the view that the ultimate decision on the matter should be left with national legislators. The possibility to override the obligation to buy in securities by contract went relatively far, going contrary to the aim of effective investor protection – this issue might be worth being considered for EU-wide harmonisation. Furthermore, it was noted that the Advice of the LCG went further than the Unidroit draft by not providing for a period during which intermediaries had time to consider replacing missing securities without any legal consequences. On the basis of the above, the issue needed to be addressed in the future Advice.

20. Article 20 of the Unidroit draft ("Limitations on obligations and liabilities of intermediaries") – The LCG discussed whether the future Advice should elaborate further on this. In order to comply with Unidroit, the legal framework needed to follow the same line on this issue; however, this could be achieved on the Community level or on national level. As the liability issue was not closely connected to the rest of the substance of the work, there was no clear need for the LCG to address this issue. Consequently, it should remain within the competence of national policy makers.

21. Article 24(1) of the Unidroit draft ("Making possible holding through intermediaries") – the LCG had considered the issue for its *2006 Advice* but, at the time, it appeared to be addressed, at least for equities, by the draft of the Shareholders' voting rights directive ("SRD"). Actually, the current version of the draft SRD did not include such a rule. At any rate, the issue did not seem to be problematic, as intermediary holding was probably permitted in all EU Member States (to be checked in the *Compendium*; if at all, the issue would better be covered by Subject 2).

22. Article 24(2) of the Unidroit draft ("Recognition of holding by person acting in own name on behalf of another person") – there was agreement that this issue was actually important as there were Member States in which such a holding pattern was expressly forbidden. However, this was clearly a policy decision. Therefore, instead of trying to eliminate such rules, the Advice should emphasise the effect of a book entry which would always grant the minimum rights as set out in the Advice (*cf.* also section 5.1.2 and 5.1.3 of the *2006 Advice*) even in cases where the above mentioned holding pattern appeared in the holding chain. The LCG recognised that the exercise of voting rights (and maybe other rights) might be hampered in this case. However, such a "compromise" solution appeared to be acceptable. Reference was made to Article 13(2) of the SRD which partly addressed the issue. As no clear result could be achieved on this

issue, it should be illustrated in the future Advice leaving any further decision to policy makers.

23. Article 25 ("Set-off") – though there might be clear advantages for banks from such a rule, the LCG agreed to leave out this issue, given its high complexity and the potential dangers for the holding system in a scenario where set-off was possible.

24. The LCG did not take any position on whether one of the above issues should be brought to the attention of the Commission with a view to the upcoming negotiations at Unidroit.

25. In this context, it was mentioned that the LCG had not yet taken a position regarding the question of the extent to which its own work should reach in the field of what is commonly defined as “regulatory powers”, though admittedly the distinction between what ought to be defined as “regulatory” on the one hand and what should be considered as “civil law rooted” on the other hand was difficult to make.

Consideration of document LCG-6 (No. 4c on the agenda)

26. The LCG decided to address the issues in reverse order.

– Financial stability and investor protection

27. It was highlighted that, within the EU, the SFD and the MiFID already addressed these concerns specifically. Therefore, the LCG could take these two measures as the starting point for its exercise. To this end, it would be necessary to make a detailed comparison between what was already provided and the ideas of the LCG.

28. It was pointed out that the SFD dealt exclusively with the CSD level within the holding system and that the risk of a chain reaction had not been addressed so far. Furthermore, the answer to many of the issues raised in section 1 of document LCG-6 would depend on the answers given to the prior questions on stability and investor protection in section 2 (e.g., who had priority in a contest between intermediary and third party over collateral, etc).

29. It was recalled that existing Community rules on systemic stability were narrow in scope and partly outdated. Consequently, the task of the LCG was a multi-faceted exercise: (a) issues already included in the Advice needed to meet the high EU standards of financial stability and investor protection; (b) regarding the issues that go beyond the current Advice, the LCG needed to assess whether sufficient regard was being given to the above principles; (c) the LCG was called upon to assess whether the entire structure, i.e. the interaction between the various measures, was workable; (d) gaps in the current Community legislation which had not been addressed so far, e.g. the integrity of an issue, needed to be identified.

30. Unidroit draft Article 23 was presented as an example for how the LCG could go beyond existing standards: though it addressed similar issues as the SFD, it went further than the latter, by (a) covering clearing systems and (b) dealing specifically with the finality of transfers.

31. Others claimed that the goals of the work of the LCG (stability, and/or investor protection, and/or efficiency) should be more clearly highlighted. Sometimes it was difficult to allocate rules to one of those objectives.

32. Some Members pointed out that issues of systemic stability and investor protection were addressed by supervisory authorities and that the LCG might not be the

right forum. The mandate of the LCG called for the identification of areas in which decisions needed to be taken by policy makers. Therefore, the LCG should concentrate on a solution regarding the issue of book-entries and all directly-related issues.

33. Others replied that there was a sphere beyond the pure abstract legal sphere. Systemic risk and investor protection were not isolated issues as they were closely connected with legal questions. The Advice of the LCG needed to take a position on where exemptions from general principles were necessary in order to allow regulatory measures. When discussing these exemptions, systemic stability and investor protection needed to be considered. With respect to investor protection it was pointed out that this was not just a matter of regulatory law but the core of Community legislation in the field of financial markets. Therefore, the LCG Advice clearly had to give importance to that issue.

– *Other issues*

34. Limitations on obligations and liability of intermediaries [*cf.* 1.m.] – the LCG discussed the possibility of limiting the liability of the intermediary (in particular by private agreement between the intermediary and its account holder) and whether it should be addressed by a harmonised rule. One important example where such a rule came into play was the question of whether an intermediary could be held liable for breach of obligation of the upper tier intermediary. In principle, there was agreement that the result of the breach of obligations should be left to the national legislator. However, a strong group within the LCG believed that where the LCG Advice established duties of an intermediary, it had to consider at the same time the question of whether the liability for the breach of that duty should be capable of being undercut by national law. Opinions within the LCG remained divided on this issue.

35. Harmonised non-consensual security interests [*cf.* 1.l.] – given the high political importance of non-consensual security interests (for example, for claims of intermediaries, employees or the treasury), there was common understanding that the LCG should not venture into the substance of this subject, but should limit itself to integrating the rank in priority of such interests within the priority rules of the book-entry scheme.

36. Recognition and prioritisation of legal positions created outside the future regime [*cf.* 1.k.] – the prevailing view was that priority rules in this regard were needed.

37. Right to hold securities outside the system [*cf.* 1.i.] – there was agreement that the LCG should not venture into the issue of mandatory dematerialisation. It might be signalled as a policy issue.

Future work on Subject 1 (No. 4d on the agenda)

38. By November 2007, an interim report was to be delivered to the Commission. Therefore, the greatest part of the work on substance should be done from now on over the summer. The co-ordinator of Subject 1 and the secretariat would jointly prepare a list of issues to be dealt with, including a calendar setting out the relevant deadlines. In a conference-call amongst the members of the subgroup, work should be divided up between them, probably working in pairs. At the upcoming September 2007 meeting, the LCG would consider the revised text of the Advice on Subject 1 and give its input. During the month of October this input would be included, before the LCG adopted the interim report at its November 2007 meeting.

Subject 2 – Corporate Actions (No. 5 on the agenda)

State of play (No. 5a on the agenda)

39. The co-ordinator of the working group on Subject 2 stressed that the work would focus on the relationship between investor and issuer and the legal obstacles and uncertainties stemming from the fact that an intermediary was placed between them, whereas Subject 1 concerned the relationship between account holder and account provider. She referred to the overlap with other initiatives (SRD, FISCO/CESAME {covered by the informal 3-party meetings, *cf. infra*}, and Unidroit, in particular draft Article 5).

Methodology; evidencing the investor-issuer relationship; points of contact with Unidroit (No. 5b-d on the agenda)

40. Two assumptions were at the basis of all future analysis: first, evidencing the entitlement and identifying the entitled person were the key functions of all securities; and second, the final investor was the person that was ultimately entitled to benefit from the rights flowing from the securities. The second principle was also addressed in the draft Unidroit Convention, Article 5(1)(a), as well as in the draft SRD.

41. One of the main issues identified during the last meeting was whether and to what extent the LCG could propose imposing duties on account providers to facilitate or perform the exercise of corporate rights of the shareholders. It seemed that generally intermediaries interacted basically in the field of "basic" or "mandatory" corporate actions (like collection of dividends) but were less involved in other types of corporate actions (like forwarding *ad hoc* warnings) if not on a voluntary or contractual basis. In this context it was noted that Article 5 of the draft Unidroit Convention seemed to give to the account holder the right to exercise all kinds of corporate actions and was not restricted to specific ones or a specific type of corporate action.

42. The LCG discussed whether such a broad approach was appropriate in the EU context or whether it would be more appropriate to restrict the duties of the intermediary with respect to the investors' rights to the processing of specific types of corporate rights.

43. It was pointed out that any consideration regarding widening the duties of account providers needed the acceptance of market participants against the background that their duties were already relatively broad (e.g., receive information from an exotic market, translate it, organise its channelling through the holding system in a minimum time, decide what type of information had to be brought to the investor's attention, etc.), always taking into account that nowadays a variety of alternative information tools were available, in particular the website of the relevant issuer. Equally, the need for additional duties on the intermediary had to be assessed against the fact that there were different types of investors (professional/advanced /consumer).

44. The question of whether the exercise of a defined group of corporate rights had to be facilitated by the account provider and whether any assistance that went further could be provided on a voluntary basis was basically a cost issue. In cases where both the investor and the account provider agreed on additional duties, the cost involved would certainly rise.

45. It was stressed that the LCG Advice should not go in the direction of trying to define the nature of "the right" and that Unidroit draft Article 5(1) should be retained as a benchmark regarding this question. This provision, after intensive and long international negotiations, seemed to strike a workable border-line between the exercise of corporate rights and the nature and further content of "the right", *cf.* Unidroit draft Article 5(1)(d). The aspect of nature and content of "the right" had to be left to national law and should therefore remain untouched by the future LCG Advice. However, Article 5(1), which did not by itself establish "duties" of the intermediary, needed to be read in the context of Article 5(2) and Article 6, which finally established the obligation of the intermediary to act as addressee and facilitator with respect to the exercise of the right.

46. Consequently, the concept of Unidroit was described as very broad: Article 5 enabled investors to exercise all rights flowing from the securities, without making any distinction, seconded by Article 6 which established the relatively unclear obligation to "take appropriate measures". The question was, whether the LCG, in its own Advice, should refine this broad approach and, in particular, develop a set of mandatory corporate actions.

47. On this issue, the LCG concluded that

- a) it should be highlighted in its Advice, including an illustration of the different methods to solve it, in particular a proposal for a basic catalogue of obligations for intermediaries in connection with corporate actions (*cf.* for a first draft in the annex of document LCG-8);
- b) some corporate actions could be clearly identified as mandatory, i.e. the intermediary had the duty to process them (e.g. collection of dividends), others clearly as non-mandatory, e.g. shareholders' statements in the AGM (which the intermediary was probably not bound to process);
- c) the final decision on those corporate actions which are located in a "grey zone" between mandatory and non-mandatory should be left to policy makers, including the option that the intermediary's duties with regard to those issues were generally subject to a voluntary agreement between the parties.

Future work on Subject 2 (No. 5e on the agenda)

48. The co-ordinator concluded that the following three issues would be addressed by the working group:

- a) Legal issues in the context of dismantling Giovannini Barrier 3:
 - i) duties and rights of account providers in the context of the processing of corporate events;
 - ii) duties and rights of issuers vis-à-vis the account provider in the context of the processing of corporate actions; and,
 - iii) other legal issues that were not directly included in the mandate but which appeared in the course of the work of other EU Commission expert groups, which generally dealt with non-legal issues. Several of those issues were brought to the attention of the LCG at the last three-party meeting with CESAME and FISCO:
 - (1) a legal definition of record date;
 - (2) a legal basis for electronic communication by the issuer;

- (3) a legal obligation to disseminate information by means of electronic communication;
 - (4) issuer's liability when translating documents; and,
 - (5) a legal definition of the moment of transfer of ownership.
- b) Policy issues in relation to corporate action processing (e.g. risk, liability, cost-bearing in the processing of corporate actions).
- c) Research, i.e. information on legal treatment of particular corporate events in Member States would be gathered, starting from question no. 34 of the *Compendium*.
49. Work would be organised in a way similar to future work under Subject 1 (*cf. supra*).

Subject 3 – Location of securities (No. 6 on the agenda)

State of play; points of contact with Unidroit (No. 6a-b on the agenda)

50. The co-ordinator of the working group on Subject 3 informed the LCG that work was carried out on the basis of assumptions and guidelines as set out in the presentation given at the last meeting. After additional analysis of the findings in the *Compendium*, a first draft would be circulated to the LCG.

51. She drew the attention of the LCG to the importance of conflict-of-laws rules in connection with the issue of location of securities. The fact that the Hague Securities Convention was blocked in the process of ratification raised the question of whether Subgroup 3 should give, within its scope of work, some thought to the conflict-of-laws question and possible solutions.

52. Members agreed that the issuer-investor relationship was governed by the *lex societatis*, whereas the issue was governed by the *lex rei sitae*. The investor should have the same corporate rights (flowing from *lex societatis*) irrespective of the market on which the securities in question were traded and through which CSDs the securities were held. However, this was not yet reality in the EU financial market. Currently, difficulties arose, for example, where securities which were issued in one market were not allowed to be traded in other markets (e.g. securities on sport bets), or where issuers like those which issued secured bonds (e.g. German "Pfandbriefe") were restricted in their choice of where to issue. Interoperability could only be obtained by EU law; the Unidroit draft Convention did not address the issue. There was, however, agreement on the fact that the subject was politically sensitive.

53. The Group concurred that, from the point of view of Subject 3, there were no connecting points with the Unidroit draft that needed specific action at the moment.

Future work on Subject 3 (No. 6c on the agenda)

54. According to its coordinator, the working group had to elaborate whether the problems/restrictions only occurred in the case of shares or also in the case of bonds. In addition, it was not clear whether, after the issuance of the shares, the problem of moving

shares from one jurisdiction to another jurisdiction in another Member State was still relevant or whether it had been solved. Furthermore the working group had to analyse whether a free choice of the system of settlement would solve current problems in the future. Equally, regard had to be given to the question of whether dematerialisation was decisive in this context.

55. As the fact-finding of the sub-group was still ongoing, the working group was currently considering whether a short questionnaire should be prepared in order to elaborate on issues not yet covered in the *Compendium*. Working group meetings were planned in the coming months.

Any other business and closing (No. 7 and 8 on the agenda)

56. The next meetings will be held on **10/11 September 2007** as well as on **15/16 November 2007** in Brussels.

57. The meeting closed at 17:45.

Contact:

Philipp Paech, Telephone:(32-2) 2962612; e.mail: philipp.paech@ec.europa.eu