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TABLE OF CONTENTS

TABLE OF CONTENTS	2
1. SUBJECT 1: PRINCIPLES FOR NEW LEGISLATION ABOUT THE LEGAL EFFECTS OF BOOK ENTRIES	4
1.1. The legal features of book-entry rights	5
1.1.1. Minimum features (harmonised)	5
1.1.2. Additional features (not harmonised).....	5
1.2. Acquisition of book-entry rights [□]	6
1.2.1. Which account is meant?.....	6
1.2.2. Types of securities accounts.....	6
1.2.2.1. Omnibus or segregated accounts?	6
1.2.2.2. Accounts provided by authorised entities?.....	6
1.2.3. Other methods than book entry	7
1.2.4. Effectiveness against third party	7
1.2.5. Carve-out for legal nature and content of the position received.....	7
1.2.6. Moment at which the account holder "receives" the legal position	8
1.3. The account holder – account provider relationship	9
1.3.1. Exercise of book-entry rights against the intermediary and/or the issuer.....	9
1.3.1.1. General rule	9
1.3.1.2. Alteration by contract.....	9
1.3.1.3. Diligence and liability of the intermediary.....	10
1.3.2. Rights regarding transfer	12
1.3.2.1. Person entitled to give instructions	13
1.3.2.2. Addressee of instructions	13
1.3.3. Obligation to follow the instructions.....	13
1.3.4. Right of retrieval.....	14
1.4. Methods regarding the creation of security interests	15
1.4.1. Should the Advice deal with methods of providing security interests and to what extent is there room for this outside the FCD? Should input be given to the process of FCD revision?	16
1.4.2. Effectiveness against third parties	17
1.4.3. Inclusion of granting a security interest by way of a book- entry.....	18

1.4.4.	Limited interests other than security interests.....	18
1.4.5.	Is there a conceptual difference between a security interest created by a book-entry and a designating entry?.....	18
1.5.	Priority	19
1.5.1.	Delimitation from bona fide acquisition.....	20
1.5.2.	Assimilation of "designating entry" to credit.....	21
1.5.3.	Need for priority rules to cover limited interests.....	21
1.5.4.	Derogation regarding priorities.....	22
1.5.5.	Alteration of priority rules by mandatory operation of law.....	23
1.6.	Bona fide acquisition.....	23
1.7.	Rules on "validity" etc.....	24
1.7.1.	Delimitation of "finality", "validity", "effectiveness", "reversibility", etc.....	25
1.7.1.1.	Finality.....	25
1.7.1.2.	"Credits constituting evidence".....	26
1.7.1.3.	Effect of validity.....	26
1.7.1.4.	Invalid book-entries.....	27
1.7.1.5.	Reasons for invalidity.....	27
	- Lack of instruction/authorisation.....	27
	- Underlying obligation.....	28
	- Conditions.....	28
	- DvP	29
1.7.1.6.	Reversals/Voidance.....	29
1.7.1.7.	Effect of invalidity, reversal and voidance.....	30
1.7.1.8.	Transparency of conditional/blocked book-entries.....	30
1.7.2.	Connection to insolvency law.....	31
1.7.3.	Establishing criteria for the above.....	32
1.7.4.	Develop interface to national law regarding this issue.....	32
1.8.	Integrity of the system.....	32
1.8.1.	Background.....	32
1.8.1.1.	Definition of "integrity".....	32
1.8.1.2.	Various approaches to guarantee integrity.....	33
1.8.1.3.	Leading questions towards the right solution.....	34
1.8.1.4.	Various means to avoid imbalances at disposal.....	35
1.8.1.5.	Means to rectify unavoidable imbalances.....	36
1.8.1.6.	Role of segregation.....	37
1.8.2.	Proposed solution – is legal action required?.....	38

1.8.2.1.	“No credit without debit”	38
1.8.2.2.	Use of conditional bookings.....	39
1.8.2.3.	Reverse bookings for erroneous bookings	39
1.8.2.4.	Buy in of “missing securities”.....	39
1.8.2.5.	Drawing on the own funds of the intermediary.....	40
1.8.2.6.	(Pro-rata) loss sharing	40
1.9.	Holding through intermediaries.....	41
1.9.1.	Allowing intermediation.....	41
1.9.2.	Holding in Own Name for the account of another person- Interconnectivity of systems.....	42
1.9.3.	Exercise of corporate rights attached to securities	43
1.9.4.	Corporate rights conferred upon intermediaries.....	45
1.10.	Attachments.....	46
1.10.1.	Introduction / Delimitation.....	46
1.10.2.	Prohibition of upper tier attachments	47
1.10.3.	Prohibition of attachments of segregated client accounts by creditors of the intermediary	49

1. SUBJECT 1: PRINCIPLES FOR NEW LEGISLATION ABOUT THE LEGAL EFFECTS OF BOOK ENTRIES

Credits to securities accounts are a source of rights for the account holder, as the account holder acquires a "book-entry right" upon a credit being made.

Since the *2006 Advice*, the expression "book-entry right" is used. This is a generic term, covering the legal position which is acquired when a credit to a securities account is made, regardless of the legal concept which is at the basis of this legal position and, encompassing any variations of those concepts, all as found within the EU. The expression "book-entry rights" is thus neutral between the ranges 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" should not be taken as indicating that the legal positions are being given a name in the legal sense.

In some countries a concept parallel to the one of book-entry rights already exists 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.

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 XXX below.

1.1. The legal features of book-entry rights

The new legislation does not aim at any reconstruction or fundamental change to national ownership concepts, which should be preserved. Rather, introducing the model of book-entry rights will lead to harmonisation in the EU countries in the sense that the legal position given to an account holder under the national legal framework comprises a set of minimum features. In a context of cross-border securities holding and transfer, consequently, relevant parties can rely on receiving book entries that possess these minimum features. However, given the neutral approach of future EU legislation, any new legislation will not replace existing national property laws concerning securities; therefore, the harmonisation of minimum features notwithstanding, national law will remain free to determine any additional legal elements of the position an account holder receives upon credit.

1.1.1. *Minimum features (harmonised)*

A book entry right shall, regardless the legal concept of rights in/to securities in the relevant jurisdiction, put the account holder in the following position:

- 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 another person, to pledge or otherwise charge the rights, to limit the rights in any other way, to move the book-entry right to another account, including by terminating the account with the account provider;
- 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;
- 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;
- 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.

1.1.2. *Additional features (not harmonised)*

The rights that are required to arise are a minimum: in many cases, Member States laws can and will confer further rights, mainly stemming from corporate law. However, if such laws are incompatible with the aim of the new legislation, which is to recognise the legal effects of book entries, they will need to be conformed.

[Examples: what is meant]

1.2. Acquisition of book-entry rights^[1]

General rule is that the legal effects of a book entry in favour of an account holder arise upon a credit entry to the securities account of the account holder with the account provider. National rules incompatible with this principle should be changed.

1.2.1. *Which account is meant?*

In the 2006 Advice, the formula "credit to the account provider's books" had been used. There is agreement that no account other than the account holder's securities account with the account provider was meant. In order to avoid misunderstandings, reference will be made hereinafter in all cases to "the securities account".

A different issue is what happens if securities meant to be delivered to an investor are credited to the securities account of its account provider i.e. are credited to the "account provider's books" but at the time of the insolvency of the account provider are, for technical reasons, not yet credited to the account of the investor.

1.2.2. *Types of securities accounts*

As regards the character of the securities account to which a credit needs to be made in order to acquire book-entry accounts, two issues merit further analysis.

1.2.2.1. Omnibus or segregated accounts?

The first question is, whether the credit could be made to any type of securities account – individual segregated accounts or omnibus accounts? There is agreement that there was no justification for interfering in existing varied and legitimate market practice, such as 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. Consequently, credits to both omnibus and segregated accounts confer book-entry rights upon the account holder.

1.2.2.2. Accounts provided by authorised entities?

The second question relates to the issue of non-regulated account providers. MiFID will bring some changes to the rulebook for safeguarding client financial instruments (Article 13.7 MiFID and Articles 16 and 17 of the Commission's Directive implementing MiFID). It could be wise to wait and see the effects of the new rules in MiFID before going forward with a proposal, i.e. for the time being only regulate that the credit on a securities account should have the above described legal effect without addressing the issue whether "securities accounts" relates only to all accounts with no restrictions or only to those provided by supervised financial institutions under MiFID. Safeguarding and administration of financial instrument for the account of clients is, under MiFID, an ancillary service (Annex 1, section B (1)); however, MiFID itself does not provide for an answer to that question. In the Unidroit draft, the answer to this topic appears to be equally unclear.

[¹ The background note was prepared by Lars Afrell and Joanna Benjamin]

The *2006 Advice*, in its section 6.2.2, stated that the new legislation should cover all, and not merely those who are licensed. There are good reasons for both options, and opinions within the Legal Certainty Group are divided:

Some think that the rules should be limited to certain account providers (credit institutions, securities firms, CSDs and ICSDs); the main reason being that it was difficult to analyze the effects of a rule that made credits by unauthorized providers legally binding. Furthermore, it would be very cumbersome to change property laws and insolvency laws for unlicensed entities in a way that give account holders the same protection as in case of the account provider being a supervised financial institution.

Others are of the opinion that MiFID and Member State regulatory regimes would restrict the ability of unauthorized institutions to offer custody services. If, notwithstanding such provisions, custody was offered by an unauthorized institution, there seemed to be no policy justification for denying the account holder the substantive law protection available to account holders dealing with authorized institutions. If anything, such protection would be more necessary.

1.2.3. Other methods than book entry

The question of whether there should be and how to handle other methods for the acquisition of book-entry rights is closely related to the issue how a new legislation will relate to existing national property and securities laws. Creating a system where all relevant rights and interests should be registered on the relevant account appears to be the right way. There will be of course certain rights created by mandatory operation of law but their number should be as limited as possible. Credits on an account should be in the first line, whereas all legal positions acquired by other methods should be regarded as of an “inferior quality”. In short, all information about the securities should be found on the account with the exception for certain rights created by operation of law. To what extent “informal dealings” should be possible needs to be discussed by the LCG.

1.2.4. Effectiveness against third party

A credit on a securities account should as stated in the Unidroit draft be enough for the protection against third party (cf. Articles 5 (1) (b) and 7 (2) Unidroit draft).

Subject to the above, book-entry rights should be considered as being generally effective against third parties. This is especially relevant in the event of non-authorized disposal of such rights, subject to the application of the good-faith rule, and of actions of the account provider’s creditors. The principle is expressly recalled by the Unidroit draft Convention (Article 5.2.(a)). The Advice deals with this issue in the context of rules on priority (5.3), bona fide (5.4) and insolvency of account provider (5.6). However, a more explicit reference may be introduced in the future EU legislation on the line of the Unidroit draft Convention.

1.2.5. Carve-out for legal nature and content of the position received

The new legislation does not replace existing national property laws, nor 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 (see also 6.1).

1.2.6. *Moment at which the account holder "receives" the legal position*

The account holder becomes entitled to book-entry rights as of the moment at which the credit entry is made on the securities account and ceases to be entitled to them upon a debit entry being made. The issue was raised in Document LGC-6 d):

It is still unclear whether future EU legislation should address the issue of "moment of transfer". This term aims at describing the point in time in a sequence of factual elements which is regarded, under the applicable law, as marking the point where the asset is definitively passed from the seller to the acquirer, e.g. in the context of property-based systems, the point in time at which the acquirer becomes proprietor. The identification of this decisive fact (which could, for example, consist of the crediting to an account, or of the crediting to one plus the debiting to another account) is regarded as crucial in various contexts, as for instance regarding the finality of an acquisition or the determination of the person entitled to exercise corporate rights. The 2006 Advice touches upon the issue in section 6.1 very much on the surface. Some Members advocate rules setting a common framework for the moment of transfer for the above-mentioned purposes. Others believe that this question could not be resolved as it is an integral conceptual part of the underlying national law governing acquisition and disposition, which should be modified to the extent necessary under the functional approach. A third opinion points out that if it was impossible to come to an agreement on the moment of transfer, at least, in functional terms, the "validity" of an acquisition and disposition needed to be harmonised. A fourth voice reminds that defining the moment of transfer it appeared logically impossible, as in modern settlement systems no "transfer" from one person to another person occurred.

The two reporters on this subject went with this last argument: in practical terms, the rules proposed above would solve many problems about the moment of transfer. Probably, there was no transfer from one person to another in modern securities settlement system (SSS). And it appeared therefore illogical to try to find a moment for that non-existing transfer. The final credit to a specific securities account is often the result of a chain of transactions or operations in the SSS. Those transactions or operations could take place between intermediaries, often also between intermediaries on different levels or tiers in the process. Against that background it could be very legally risky and technically difficult to try to define the right moment. A rule about the moment of transfer must give room to innovations and development in the field of securities settlement and account providing. Furthermore the concept of "moment of transfer" is heavily influenced by the traditional model of holding and transferring physical certificates and the legal thinking in that environment though in all systems, the by far greatest part of securities is dematerialised or, at least, immobilised.

Consequently, no rule should be proposed about moment of transfer. It would be sufficient to state, as above, that the account holder becomes entitled to book entry rights as of the moment at which the credit entry is made on the account holder's account with the account provider, and ceases to be entitled to them upon a debit entry being made to this account (subject to specific rules dealing with "conditional credits").

1.3. The account holder – account provider relationship²

The examination of the account holder-account provider relationship requires consideration of a number of key concepts.

1.3.1. *Exercise of book-entry rights against the intermediary and/or the issuer*

1.3.1.1. General rule

According to the Advice, book entry rights listed under should be exercised against the account provider. The rights of disposal and retrieval (cf. 2006 Advice sections 5.2.1.-5.2.2.) are characterized by the fact that they may be exercised only against the relevant intermediary (see Article 5.2.(c) of the Unidroit draft Convention). The special nature of multi-tiered holding systems requires that such rights may be exercised only against the account provider who maintains evidence of the rights of the account holder. Corporate rights (the rights attached to securities) may be exercised, to the extent allowed by the law of issue, directly against the issuer³. The Advice does intend to dispute this basic principle. It aims to enable the account holder to rely on the co-operation of the account provider for the exercise of its own rights, i.e. it regulates how the account provider should facilitate the exercise of such rights.

The reverse side of book entry rights is the obligations of the account provider to comply with the account holder's instructions. The Unidroit draft Convention requires the intermediary to take the appropriate measures to enable the account holders to exercise those rights (Article 6). The *2006 Advice* recalls under section 5.9.5. the duty of the account provider to follow the account holder's instructions in relation to the account. A more explicit link between such duty and the rights set out in sections 5.2.1.1. and 5.2.2.2 of the *2006 Advice* may be inserted in the same way that sections 5.9.3. and 5.9.4. deal expressly with the corporate rights set out in sections 5.2.1.3. and 5.2.1.4.

Proposal:

- The Advice should be made more explicit as regards the duty of the account provider to execute instructions of the account holder relating to the exercise of the rights of disposal and of retrieval.

1.3.1.2. Alteration by contract

Section 5.11. of the *2006 Advice* provides that the rights, and the correspondent duties, arising from par. 5.2.1.1. and 5.2.1.2. cannot be altered by contract⁴. This

[² The background note was prepared by Angel Kalaidijev and Federico de Tomasi.]

³ The Unidroit draft Convention states also that the “corporate rights” may be exercised against the intermediary, the issuer or both, in accordance with the Unidroit draft Convention, the terms of issue and the law of the issue.

⁴ As regards the exercise of corporate rights the issue will be considered within Topic no. 7. However it seems clear that the contract should not alter the basic right to receive and exercise corporate rights.

principle recognises the right of disposal as essential which in most jurisdiction is linked to proprietary nature of book-entry securities. The correspondent text of the Unidroit draft Convention contains elements of ambiguity. From one side the latter specifies (Article 6) that the intermediary may not be requested to take any action that is not within its power or to establish a securities account with another intermediary. These qualifications should be interpreted in a restrictive way in order to avoid a circumvention of the basic requirement. Some clarifications on the proper meaning of this qualification would be appropriate. Furthermore, Article 20 of the Unidroit draft Convention stipulates that “the obligations of an intermediary under this Unidroit draft Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Unidroit draft Convention Law...”. This qualification may strongly weaken the effectiveness of the Unidroit draft Convention to the extent that the basic obligations therein set out may be derogated by non-Unidroit draft Convention Law.

Proposals:

- The Advice should be clarified as regards the exact scope of the basic rights and duties related to book-entry rights which may not be altered by contract.
- Article 20 of the Unidroit draft Convention: does the provision mean that Contracting States may derogate to the obligations of the intermediary set out by the Unidroit draft Convention? Should Member States ask for an amendment of this provision?

1.3.1.3. Diligence and liability of the intermediary

It should be considered whether the prohibition of alteration by contract of the rights at hand should be accompanied by the requirement to act according to professional diligence and a prohibition of limitation or exclusion of liability for infringements of the correspondent duties. It has been just mentioned that the Unidroit draft Convention makes reference to non-Unidroit draft Convention law on the subject. The *2006 Advice* deals with the issue of liability only with reference to the account provider’s duty to maintain sufficient assets at the upper tier to match the balance of credit on the account holder’s account (cf. section 5.9.1.). It is therein submitted that the duty to replace missing assets or failing which to reimburse the value of the assets is subject to contractual agreement and applicable rules on limitation and exclusion of liability (sections 5.9.6., 5.11.)⁵.

In intermediated systems the protection of the rights of account holders strongly depends upon the diligent accomplishment of duties of the account providers. The same integrity of the issuance is linked to such duties. The account provider should perform its obligations with due care. It should act honestly, fairly and professionally in accordance with the best interests of the account holders and should take reasonable steps to ensure continuity and regularity in the performance of its obligations. The account provider should employ appropriate and

⁵ In fact this assumption seems to contradict the statement on the impossibility to alter by contract the duty to maintain sufficient holdings (5.11 makes reference to 5.9.1.).

proportionate systems, resources and procedures. It should also apply sound administrative and accounting procedures, internal control mechanisms and effective control and safeguard arrangements for information processing systems. The account provider should implement procedures and arrangements which provide for the prompt, fair and expeditious execution of the orders of the account holders.

The requirement to act according to professional diligence should not be circumvented through contractual clauses which limit liability. The answers to the questionnaire shows that in a number of jurisdictions (Spain, Portugal, Italy, Sweden, Lithuania) liability cannot be excluded or limited, in others (France, Netherlands, Belgium, Luxemburg) such limitations may be challenged on the grounds of lack of reasons, abuse.

EU legislation already in force should be also considered. The Directive 93/13/EEC of 5 April 1993 concerning the unfair terms in the consumer contract seems to exclude the enforceability of contractual limitation to the account provider's liability, at least if such a clause would be included in a contract between an account provider and an account holder who is a consumer, in the meaning of Article 2 of such a Directive⁶.

In fact the clauses which have the effect of limiting the seller's or supplier's liability vis-a-vis the consumer, including the case of financial services contract (arguing from the derogations stated in the Directive's Annex), are considered by Article 3.3 (which indeed recalls the Annex of the Directive)⁷.

According to Article 3.3 "Member States shall lay down that unfair terms used in a contract concluded with a consumer by a seller or supplier shall, as provided for under their national law, not be binding on the consumer and that the contract shall continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair terms".

A proposal for a minimum harmonization of the liability regime may distinguish between liability for actions of third parties (upper-tier intermediaries) which may for instance be limited to the proper selection of intermediaries, and liability for the account provider's action, which should not be excluded or limited in the event of wilful misconduct or negligence. However it should be considered whether limitation of liability for actions of third parties is compliant with the above mentioned provisions of Directive 93/13.

⁶ According to the lett. b) and c) of article 2 the 'consumer' is "any natural person who, in contracts covered by this Directive, is acting for purposes which are outside his trade, business or profession" while the 'seller or supplier' is "any natural or legal person who, in contracts covered by this Directive, is acting for purposes relating to his trade, business or profession, whether publicly owned or privately owned".

⁷ According to lett. b) and n) of the Annex of the mentioned Directive, the terms of the contract which have the object or effect of: "(b) inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of offsetting a debt owed to the seller or supplier against any claim which the consumer may have against him; (n) limiting the seller's or supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality"

Proposal:

- The Group may consider whether EU legislation is needed to require account providers to act according to professional diligence as regards the performance of the basic rights and duties related to book-entry rights and to harmonize the liability regime of the account providers.

1.3.2. Rights regarding transfer

The *2006 Advice* recognizes (section 5.2.1) the basic right of each account holder to instruct the account provider to make a book entry on the account as to dispose of the rights in favour of a third party. Disposal may imply transfer of title, creation of pledge, charge or other limited interests.

The Unidroit draft Convention provides that the account holder has the right to dispose of his securities by instructing the account provider (Article 5.1(b)). Article 18 regulates the correspondent duty of the intermediary to give effect to the instruction given by account holder. Article 18.2. lists the exception to the rule, i.e. cases when the intermediary is entitled or obliged to recognize the rights of other persons. Such rights may arise from the account agreement or other agreements to which the account holder has given his consent (a), from other interests effective against third parties (b), from judicial or administrative decisions of competent jurisdictions (c), from applicable provision of law (d), from the rules of a SSS, when the intermediary is the operator of the system (e). The Unidroit text considers also the case (Art. 5.3) that the account holder has acquired a limited interest by credit on its securities account, i.e. a pledge or an usufructus. In such case it is left to non-Unidroit draft Convention law the determination of any limits on the exercise of the rights arising from credit and among them, the right of disposal.

The right of disposal and of the other rights arising from book-entry on securities accounts raise various questions⁸. Most of them do not require regulation at EU level and can be dealt with by the applicable national law or by the account agreement. Some topics however require harmonisation. These are:

- (i) who is the person entitled to give instructions;
- (ii) to whom the instructions should be given;

⁸ For example: who is the authorized person; who is the obliged party; is a person who has a right over a security without an account (no entry has yet been made) authorized to require from the account provider to open an account; is the issuer authorized to open an account; in case of a multi-tiered system is the ultimate account holder (at “lowest” tier) entitled to give instructions to an account provider of a higher tier; when does the right to give instructions arise; what is the legal nature of that right – can the account holder enforce the instructions in case of non-performance and what are the legal means; what type of entries shall be regulated – issue of a security, transfer, pledge, limitation, change, termination; if a pledge or a limitation of a right is entered, is the pledgee or the other person who benefits from the limitation entitled to instruct the account provider with regard to the pledge or the limitation; form of the instruction (informal, to be evidenced in written form); errors, misunderstanding (translation), interference of third parties, etc. of the instruction; withdrawal of the instruction (before or after its reception by the account provider); timing of performance by the account provider; specific requirements (if any) with regard to the change of the entry and to the termination of the account.

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- (iii) when does the right to give instructions arise;
 - (iv) what types of entries should be regulated.

Issue (iii) has been satisfactorily dealt with by the *2006 Advice* (section 5.2.2.) We will concentrate our attention on issues (i) and (ii). Issue no. (iv) is extremely important and complex. However, it belongs to the mandate of other sub-groups and to the group in charge of the revision of the Collateral Directive. Therefore we will touch upon it only in relation with the issue (i).

1.3.2.1. Person entitled to give instructions

The person who is authorized to give instructions should be the account holder, i.e. the person in whose name the account is opened. It doesn't matter whether the account holder is a physical or legal person except as otherwise provided by the national law. The Advice will have to recognize that some exceptions should be allowed on the basis of Article 18 par. 2 of the Unidroit draft Convention.

If a right or interest different from a full interest is created in favour of a third party, such as pledge or other limited interest, it should be considered whether the pledgee or the interested beneficiary should also be entitled to give instructions to the account provider with regard to the disposition of his pledge or interest. The Unidroit draft Convention has left to non-Unidroit draft Convention law the decision on the matter. The issue is clearly within the scope of the current exercise: however the answer should be left for further consideration by the Group. As a matter of fact the different nature of the rights at hand may prejudice the adoption of a common solution. In some jurisdictions the right of pledge cannot be transferred since it is ancillary to the credit relationship. On the contrary the right of usufruct may be transferred without restrictions.

Proposals:

- The Advice should be reviewed in order to recognize exceptions to the exclusive right of the account holder to dispose of book entry rights, on the basis of Article 18 par. 2 of the draft Unidroit draft Convention.
- The Group should discuss whether the right of disposal of limited interests arising from credit on a securities account may be regulated by harmonized rules at EU level.

1.3.2.2. Addressee of instructions

The account holder should be entitled to give instructions only to the relevant account provider, i.e. the account provider that maintains the securities account for the account holder (see above). Therefore, in a multi-tier system, the account holder should have no right to instruct an intermediary that is not a relevant account provider. The Advice does not need further elaboration in this respect.

1.3.3. *Obligation to follow the instructions*

The reverse side of the rights of the account holder is the obligation of the account provider to perform these obligations. The *2006 Advice* sets out, within the duties of the account provider, the duty "to follow the account holder's instructions in relation to the account". The Unidroit draft Convention regulates implicitly the

obligation of the account provider to follow the instructions of the account holder (Article 18.1).

The analysis made and the conclusion reached with regard to the standard of care requested to the account provider (cf *supra*) and to the right of the account holder to instruct the account provider (cf. *supra*) are also valid in respect of the obligation of the account provider to follow the instruction of the account holder.

1.3.4. Right of retrieval

In line with the objective of minimum harmonization, respect of market practice for holding securities, and existing property law concerning securities, the *2006 Advice* recognizes the right of the account holder to retrieve, or instruct the account provider to retrieve, securities held with an account provider, by delivery of certificate or other means. Retrieval implies exit of the securities from the intermediated holding system and from the scope of the related legislation. According to the Unidroit draft Convention and the *2006 Advice* the right is subject to both the law regulating the issue and the law applicable to the account provider.

Firstly, the law regulating the issue may exclude the right of retrieval since the securities have been issued in dematerialized form. Securities may be also issued, according to law, in immobilised form: in such case paper instruments or certificates still exist but only in the form of global certificates which are normally deposited in a CSD. Some jurisdictions do not allow issuance of individual paper certificates. Other jurisdictions grant this right or leave the regulation of the matter to the issue terms or the issuers' regulating association.

Securities may be also issued in paper form, but the law may authorize the holder of the certificate to deposit it with an intermediary; the latter shall sub-deposit the paper with a CSD. Securities will be transferred by way of book-entries and the rights attached to them may be exercised through the system. In such scenario deposit of paper certificates is normally reversible and the account holder may call for retrieval.

Retrieval is also subject to the law regulating the account provider. However in this context the law of the account provider which regulates the issue is not relevant: even if a country has opted for a full dematerialization system it may allow retrieval of securities issued in a foreign country. This is the case for France where legislation limits the scope of dematerialization to securities issue on French territory and subject to French law. The right of retrieval may be restricted by legislation which limits or prohibits holding and transfer of securities in paper form for reasons of public order, such as anti-money laundering or tax policy, or due to the fact the securities at hand are listed on the national markets.

In fact it may be discussed whether it is appropriate, in the absence of reasons of public order, that the law of the account provider may prohibit exercise of the right of retrieval when the law of issue allows it. This may create segmentation within the EU financial market and affect competition since account providers will be able (or not) to perform requests of retrieval relating to the same type of book-entry securities according to the legislation in force in the country of

establishment. Any qualification of the Advice in this respect would require an amendment of the Unidroit draft Convention.

Leaving aside the different wording, there is one material discrepancy between the provision set out by the Unidroit draft Convention (Art. 5.1(c)) and the correspondent clause of the Advice. The former empowers the non-Unidroit Convention law to decide as to whether the account agreement or the rules of the securities settlement system may restrict the right of retrieval. It is suggested not to take on board this clause because it would go against the principle of no alteration by contract of the right of retrieval. Moreover the reasons for the reference to the rules of the SSS are not clear.

Proposal

- EU legislation should not leave to the account agreement or the rules of the SSS the power to restrict the exercise of the right of retrieval.
- The Group may discuss whether it is appropriate that the right of retrieval is subject, together with the law of the issue, also to the law of the account provider.

1.4. Methods regarding the creation of security interests⁹

Generally speaking, securities credited to securities accounts (hereafter referred to as ‘book-entry securities’) will be used as collateral either by outright transfer of title to the collateral taker or by creation of a security interest for the benefit of the collateral taker over the securities or the account to which the securities are credited.

The first of these methods, outright transfer of title, falls squarely within the scope of the Legal Certainty Group. We presume that no jurisdiction within the EU prescribes different methods for outright transfer of title depending on whether or not the book-entries are being transferred for collateral purposes. Nor would we advocate that the LCG propose such a distinction.

By contrast, there exists within the EU a broad range of different types of security interest that can be created over financial instruments generally as well as over book-entry securities in particular. English law, for example, recognises fixed and floating charges, legal and equitable mortgages over book-entry securities whereas German law recognises only a pledge (*Pfandrecht*).

Different types of security interests will vary not only on the type of financial instrument to which it can apply but also in the way in which the security interest is created and perfected against third parties. Furthermore, there is likely to be considerable divergence between Member States in relation to the priority of the different types of security interest against competing security and other interests and against the competing claims of unsecured creditors.

Therefore, a number of issues are to be considered when embarking on EU harmonisation in this field:

[⁹ The background note was prepared by Geoffrey Davis and France Drummonds.]

1.4.1. Should the Advice deal with methods of providing security interests and to what extent is there room for this outside the FCD? Should input be given to the process of FCD revision?

In prior meetings of the LCG there has been a general (but not unanimous) view that issues relating to security interests should fall outside the scope of the LCG Advice in relation to a future legislation.¹⁰

While there are advantages and disadvantages in either alternative, we share the opinion that the legislation proposed by the LCG should not attempt to address the methods of providing security interests.

First and foremost, the creation, attachment, perfection and enforcement of security interests over book-entry securities are matters that already fall within the scope of the Financial Collateral Directive (*FCD*). For example:

- (i) The FCD removes the need for formalities to create, perfect or enforce security interests over book-entry securities (Art 3).
- (ii) As regards the attachment of a security interest, the FCD acknowledges that a credit to a securities account is sufficient to identify securities collateral for the purposes of evidencing the provision of financial collateral (Art 2(5)).
- (iii) The FCD addresses the issue of perfection of a security financial collateral arrangement by stating that the only perfection requirement which national law may impose in respect of financial collateral is that it be “delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker” (Recital 9).
- (iv) The FCD sets out the manner in which security financial collateral arrangements can be enforced (Art 4).

Experience suggests that any attempt to provide a further degree of harmonisation in relation to security interests would be difficult to achieve and may hinder the overall success of the project.

- (i) The Unidroit Convention achieves only a limited degree of harmonisation which is qualified in many respects by the ability of the Contracting State to declare national differences as regards the categories of person to whom it applies and the manner in which the securities can be identified (i.e. by category, quantity, proportion or value from time to time). Each of the three prescribed methods under the Convention for creating a security interest (i.e. security interest in favour of the relevant intermediary, control agreement and designating entry) is optional. We note that the Convention’s removal of formalities and its use of the concept of control as a means of perfection is consistent with what has already been implemented by the FCD.

¹⁰ See LCG-11 para 14.

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- (ii) Attempts to reform and rationalise the taking of security may prove challenging even at the national level.¹¹

Leaving the treatment of security interests and limited interests out of any future legislation on book-entry securities does create a potential flaw in the coherency of the legislation. It would become necessary to look to both the new legislation and the FCD to acquire a complete picture of the legal framework for book-entry securities. Furthermore a disparity may arise in the level of harmonisation of full interests in book-entry securities as against limited or security interests. Separating the treatment of full interests and security interests into separate legislation will also require careful scrutiny to ensure that the future legislation and future revisions to the FCD are compatible with each other to the extent that they interact. The scope of securities covered by the future legislation would, for example, need to be conformed by the scope of the FCD to ensure that there was no lacuna.

If, as we suggest, the treatment of security interests is left to the FCD, the question remains as to whether further harmonisation should be sought and whether this can be implemented within the current FCD revision process. The Evaluation Report on the FCD published in December 2006 does not make proposals for further harmonisation of substantive law in relation to the creation, perfection and enforcement of security financial collateral arrangements.

We note that the FCD currently makes no attempt to harmonise priorities among competing security interests. By contrast, priorities is an area dealt with in the Unidroit Convention and is clearly one of importance to collateral takers in determining the extent to which they can enforce their security.

- A harmonised priorities rule is one area that could be addressed by the revision process assuming that there is still time in which to consider it in that forum. In light of the variety of different security interests that fall within the scope of the FCD, such a rule would need to be broad in nature e.g. a ‘first in time’ rule based on control of the collateral.

1.4.2. Effectiveness against third parties

The draft Unidroit Convention expressly provides in Articles 5(2)(a) and 7(2) that the rights of an account holder upon a credit to its account are effective against third parties. This has the effect of giving the account holder proprietary rights as against third parties in the event of the insolvency of the intermediary or otherwise as a result of an adverse claim of ownership (subject to the account holder’s ability to rely on an innocent purchaser defence).

- The future legislation would benefit from a similar statement clarifying in functional terms that the credit gives rights that are not only enforceable against its relevant intermediary and, in certain jurisdictions, the issuer but are also effective against third parties.

¹¹ By way of example, the UK Law Commission has recently met with strong resistance to its proposals for reform of the law relating to security interests.

1.4.3. *Inclusion of granting a security interest by way of a book-entry*

The granting of a security interest or other limited interest by way of a credit entry (as opposed to an outright transfer of title) is recognised by the Unidroit Convention (Article 7(4)). Mortgages, under English law, are an example of security interests created by a control agreement but requiring a transfer of the assets to the collateral taker. Under an English law mortgage the securities may be credited to the collateral taker's account but the collateral provider retains a limited interest in the securities (the 'equity of redemption').

For the reasons given above, we believe that issues relating to the granting of security interests should generally be left to the FCD. That said, this is an area where it may be necessary to clarify the interaction of a future legislation with the FCD to the extent that both are dealing with the legal effect of rights arising from a credit.

The FCD does not appear to have fully developed this concept. It distinguishes security financial collateral arrangements from title transfer collateral arrangements solely on the basis of where *full* ownership of the collateral resides. In order for the collateral arrangement to be a security financial collateral arrangement, full ownership of the collateral must remain with the collateral provider.¹²

On these grounds, if the future legislation refers simply to the acquisition and disposal of ownership rights in book-entry securities without expressly recognising the ability to confer a security interest or other limited interest by credit, the FCD may simply recognise such transfers by credit as title transfer arrangements.

- For this reason, we would recommend that the future legislation states that security interests may be acquired and disposed by book-entries.

1.4.4. *Limited interests other than security interests*

The Unidroit Convention recognises, in addition to the full title in securities or security interests over securities, the existence of limited interests in securities other than security interests which are equally created involving a credit to an account, e.g. usufruct. However, the Convention does not attempt to characterise such interests. The 2006 Advice does not address the issue.

- We are of the view that the future legislation should recognise the ability to create a limited interest by credit in the same way as it should do for security interests. We are not convinced that there is a need to harmonise the law in relation to limited interests.

1.4.5. *Is there a conceptual difference between a security interest created by a book-entry and a designating entry?*

A security interest created by a book-entry may arise where book-entry securities are transferred to the account of the collateral taker or some other account and secured by

¹² The UK has taken a purposive approach to this issue but clarifying in its implementing legislation that a security collateral financial arrangement will arise where the obligation is secured by way of a security interest. This would cover a security interest such as a mortgage.

way of a security interest. Designating entries or control agreements do not involve a transfer of securities but must confer sufficient control on the collateral taker.

A question arises as to whether these methods of security interest should differ in matters of priority. As mentioned above, the FCD is silent on matters of priority between security interests. By contrast, the Unidroit Convention makes a distinction between them by placing security interests created by a credit in the same category as outright transfers (Article 7). As a result a collateral taker who takes a security interest by credit can defeat a prior designating entry provided that it has not notice of it (Article 12). By the same token, a collateral taker who makes a designating entry will take priority over an earlier security interest created not in accordance with the Convention whereas a collateral taker who acquires securities by credit with notice of the earlier interest will not. If both types of security interest are based upon control by the collateral taker, there seems no apparent logic for treating them differently in matters of priority. Should the collateral taker wish to take the benefit of the innocent purchaser defence it should arrange to take the collateral on an outright transfer of title rather than as a credit by way of a security interest.

As previously stated, we believe that the treatment of security interests, including priority of security interests, should be dealt with in the FCD and not in the future legislation. However,

- if we are to recognise the ability to create a securities interest by way of a credit in the future legislation it will be necessary to address whether or not a collateral taker that obtains a security interest by credit falls inside or outside any innocent purchaser defence. A similar question arises with respect to the possibility to acquire "bona fide" a collateral interest where securities stay in the account of the collateral provider.

1.5. Priority¹³

The 2006 Advice¹⁴ has set the following principles governing the priority¹⁵ of book-entry rights and the bona fide test applicable to the account holder.

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.

[¹³ The background note was prepared by Marc van der Haegen and Max Ganado.]

¹⁴ See 2006 Advice, para. 5.3 and 5.4.

¹⁵ The term "priority" refers to precedence of a credit made by book-entry over limited rights (such as a right of usufruct, a security interest ...) or subordination agreements or other waivers, which are created *inter partes*, but not reflected as a "designating entry" or an outright transfer in book-entry form. The conflict between the holder of book-entry rights by book-entry credit and any acquirer of (contractual) ownership interests on the underlying securities is governed by a different rule that gives title to the holder of book-entry rights, subject only to the *bona fide* test and the invalidity and reversal rules.

1.5.1. *Delimitation from bona fide acquisition*

The delimitation between the scope of the priority rule (above) and good faith rules is not clearly made in the 2006 Advice.

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.

From the above cited principles it cannot be derived in which cases priority rules apply and when the good-faith acquirer rule is relevant. The draft Unidroit Convention uses more elaborate and intricate wording to express both the priority rule and the bona fide rule¹⁶.

Article 13 first starts¹⁷ by indicating that the priority rule applies to interests in the same intermediated securities which are created under Article 8 (Convention methods for creating security and other limited interests) or Article 9 (non-Convention methods for acquisition or disposition of securities or an interest in securities). From this initial statement follows that securities that are acquired by credit under Article 7 are outside the scope of the priority rule and are subject only to the bona fide rule of Article 12 and the Invalidity and Reversal Rules of Article 11.

Then, Article 13 stipulates that security and other limited interests that have become effective against third parties under Article 8 (i.e. under the convention methods) have priority over any other interest created under a method permitted by the non-Convention law. Interests created under the non-Convention methods rank following chronology. Because of the reference to Article 8, the draft Unidroit Convention then goes into great detail to indicate the relevant point in time with respect to interests granted through an "agreement with the intermediary", a "designating entry" or a "control agreement"¹⁸.

Therefore, the first question for the LCG would consequently be: does it agree with the above indicated dichotomy between the rules applicable to book-entry credits (including possibly "*designating entries*" and the rules applicable to other forms of transfer: acquisition and disposition by book-entry do not follow a priority rule (who has the credit, wins; only limited by bad faith of the acquirer, see below).

¹⁶ See draft Unidroit Convention, art. 12-13-14.

¹⁷ See draft Unidroit Convention, art. 13, para. 1 and 2.

¹⁸ See draft Unidroit Convention, art. 13, para. 3 and 4 and art. 14.

1.5.2. Assimilation of "designating entry" to credit

Another question is whether the new legislation should address the rules governing the priority between book-entry interests and other methods of transfer such as "designating entries"¹⁹ or "control agreement"²⁰ in favour of the account provider.

Again, if the LCG follows the recommendation of the Topic 3 sub-group that a "designating entry" in favour of the account provider should be subject to the same legal regime in respect of priority and good faith than a book entry transfer of full or partial title to book entry securities (including a book entry transfer of a security interest), then the end result will be as explained above, i.e. that both for full-fledged book-entries and "designating entries", priority be governed by applicable national law, subject only to the good faith rule and the rules on validity and invalidity of book-entry records that will be included in the new legislation.

"Control Agreements" entered into with the account provider are a separate and more difficult subject, as in the system of the draft Unidroit Convention a control agreement is a pure contractual agreement which is not reflected in any book-entry form or designating entry in the records of the account provider.

In the light of the rule of the absolute priority of book-entry interests over any other form of interests granted in book-entry securities - subject only to good faith and the general rules on validity and invalidity of book-entry records - , it is suggested that in the new legislation no rule of priority should be recognized to control agreements which are not reflected in either a book-entry or a designating entry.

1.5.3. Need for priority rules to cover limited interests

Another question is whether the new legislation should include rules governing the priority of security interests over other interests, namely those of (i) the collateral giver, (ii) other holders of limited interests in the securities, (iii) other creditors (including other secured creditors), or, (iv) holders of mandatory rights.

Either this matter is exclusively left to the FCD or reference is made in the new legislation to the FCD, so as to ensure consistency. This appears to be the preferred approach. The LCG could nevertheless consider including security interests in the general definition of the "limited interests" that will be discussed below and that should be defined as covering all types of interests that may be created in a functional way in book-entry securities under applicable law short of exclusive rights of disposal, but including security interests.

Assuming the security interests are to become part of the general definition of "limited interests" which will then cover, besides security interests, other types of interests in book-entry securities such as usufruct e.a., the second question is whether the new legislation should address the rules governing the priority of such limited interests over other interests, namely those of (i) the grantor, (ii) other holders of limited interests in the securities, (iii) other creditors (including secured creditors), or (iv) holders of mandatory

¹⁹ See draft Unidroit Convention, art. 13, definition of "designating entry" in art. 1 (l).

²⁰ See draft Unidroit Convention, art. 13, definition of "control agreement" in art. 1 (k).

rights. This question has to be treated in parallel with the report on Topic 3 (Methods regarding the creation of security interests).

If the LCG follows the recommendation of the Topic 3 sub-group (i) that the future legislation should simply state that security interests (and other limited interests) may be acquired and disposed of by book-entry²¹, but (ii) that the rules governing priority of security interests should be dealt with in any future FCD revision process rather than in the LCG context, and (iii) that there is no need to harmonize the law in relation to limited interests, then the absolute priority granted to book-entry rights could simply be stated to extend to (i) security interests created and perfected in accordance with the FCD, and (ii) other limited interests created by book-entry and in accordance with applicable internal legislation.

The priority (i) between successive or simultaneous security interests created by book-entry, and (ii) between different limited interests created by any holder of book-entry interests (including security interests and that holder's own residual interests) shall then be governed by applicable national law, subject only to the good faith rule and the rules on validity and invalidity of book-entry records that will be included in the proposed new legislation.

1.5.4. *Derogation regarding priorities*

A fourth question is that of the scope of the derogation to be admitted for any agreement of the parties relating to the applicable priority rules ("except ... where the parties have so agreed").

To derogate from the priority granted to book-entry records or designating entries, is it sufficient that an agreement exists between the holder of book-entry rights and, for instance, a collateral taker or an usufructuary, even if (i) in the first case, the collateral is not validated and made enforceable under the FCD, or (ii) in the second case, the usufruct is not entered into by way of "*designating entry*" in the account provider's books?

It is suggested that the answer to this question be no. It is also suggested that even if the agreement is extended to the account provider (tri-party agreement), a mere agreement of that kind cannot grant absolute priority over third party rights as long as the rights created under that agreement are not registered in book-entry form (by way of book-entry transfer or designating entry).

Any future legislation should make it clear that it does not prejudice the freedom of contract between the parties having and/or acquiring full or limited rights in book-entry securities. By agreement, such parties should always be able to create not only full rights, but also limited rights on book-entry securities (including security interests) and to subordinate or waive rights vis-à-vis each other. To be valid and enforceable *inter partes* (whether before or after insolvency), such agreements need not to be recorded in book-entry form or in any other manner than as required under applicable national law. Such agreements do not prejudice or benefit to third parties, except to the extent admitted under national law.

²¹ See draft Unidroit Convention, art. 13, art. 7, para 4.

However, if an agreement to create limited rights or to subordinate or waive rights on book-entry securities exists between two or more parties (including the case where this agreement is between the account holder and the account provider), this agreement may grant an absolute priority over third party rights only if that agreement results in a book-entry or designating entry. Only a book-entry or designating entry may create an absolute priority under the new legislation over rights, interests or claims of a third party. Any agreement that is not reflected in a book-entry or designating entry may only grant a relative priority, i.e. a priority among the parties to that agreement only.

This rule might however be stated as being without prejudice to any other method provided by applicable law for the acquisition or disposition of intermediated securities or of an interest in intermediated securities or for the creation of an interest in intermediated securities and for making such an interest effective against third parties²².

1.5.5. Alteration of priority rules by mandatory operation of law

Article 13 of the Unidroit Convention contains the same exception as the 2006 Advice with respect to interests arising by mandatory operation of law^{23,24} and by agreement between the parties, but adds that such agreement does not affect third parties.

1.6. Bona fide acquisition

Another important question is whether the LCG should elaborate further on the exception that the absolute priority of book-entry interests does not arise if the account holder "knew or ought to have known that the book-entry should not have been made".

The attempts of the Unidroit Committee of Governmental Experts to further define the good faith test²⁵ are still subject to a question mark. The question of whether an acquisition has been made in good faith and the question of whether actual knowledge of the competing rights or interest is required or to what extent constructive knowledge disqualifies good faith ("ought to have know ...") is a question largely for national law and national courts to apply on the basis of the facts. The wording adopted by *the 2006 Advice* allows for constructive knowledge to disqualify good faith. The manner in which this knowledge/constructive knowledge test will be applied is a matter for the national courts to decide on. It does not appear workable or advisable to further elaborate on the exact conditions under which the constructive knowledge test should be applied, as this will essentially be a question of fact.

The LCG should determine whether it is advisable to elaborate a detailed unified definition of good faith in the context of interests acquired in book-entry form or whether it does not appear more convenient to leave the application of the test proposed ("knew

²² See Unidroit Convention, art. 9.

²³ See draft Unidroit Convention, art. 13, para. 5 and 6.

²⁴ The term "*by mandatory operation of law*" refers to any priority that is granted under applicable national law. It is not proposed to limit or further restrict this definition because of the variety of situations that may arise.

²⁵ See Unidroit Convention, art. 12, para. 4 (b).

or ought to have known ...") to the national law which will govern that issue under the PRIMA rule as applied by the various Member States.

1.7. Rules on "validity" etc.²⁶

The 2006 Advice (cf. point 5.7) states:

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

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.

The UNIDROIT draft Securities Convention - May 2007 version:

Article 7 [Acquisition and disposition by debit and credit]

1. - Subject to Article 11, intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - Subject to Article 11, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

Article 11 [Invalidity and reversal]

1. - A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not authorised to make that debit or designating entry:

[²⁶ The background note was prepared by Klaus Löber and Ulrik Rammeskov Bang Petersen.]

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to an interest granted under Article 8, by the person to whom that interest is granted; or

(b) by the non-Convention law.

2. - Subject to Article[s] 12 [and 13], the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system determine –

(a) subject to paragraph 1(a), the validity of a debit, credit or designating entry;

(b) whether a debit, credit or designating entry is liable to be reversed;

(c) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal;

(d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and

(e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.

1.7.1. Delimitation of “finality”, “validity”, “effectiveness”, “reversibility”, etc.

In order to be able to determine who acquires book-entry rights when and under which conditions, as a first step, there needs to be clarity about the concepts used. As previous statements of the Legal Certainty Group rightly note: “By the term “validity” a very heterogeneous group of legal considerations is addressed, which include aspects of effectiveness of an acquisition against third parties, validity amongst the parties, conditionality of a credit, the possibility to reverse book-entries and finality. The Unidroit draft Convention, in its Articles 7, 8, 11 and 12, follows the general rule that a credit is generally effective as against third parties, including an innocent acquirer. ...” (cf. LCG-6 sect. 1)e)).

In particular, UNIDROIT deals with the rules on certain effects of book-entry transfers (in the Convention’s terminology ‘effectiveness’, the terms “validity” or ‘finality’ are not used) and reversals thereof.

To avoid misinterpretations based on the use of pre-established concepts, it is suggested that a functional, descriptive approach is followed when assessing the relevant elements, using the findings of the 2006 Advice as a starting point.

1.7.1.1. Finality

When referring to the concept of finality, a clear distinction has to be made between two distinct concepts, which occur at different points in time:

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- The finality of transfer orders/instruction, whereby transfer orders are protected from insolvency or other unwinding risks (this is the sole concept used in the Settlement Finality Directive), and
 - The finality of a transfer, whereby entitlement to securities/book-entry rights are legally transferred to a receiving entity.

Only the latter concept is of direct relevance for the present analysis of validity of credits and book-entries, however, the finality of transfer orders may become relevant when assessing whether a valid and enforceable instruction has been given to an intermediary.

1.7.1.2. “Credits constituting evidence”

The 2006 Advice (point 5.7) states: “A credit on a securities account constitutes evidence of the book-entry rights of the account holder.”

This follows previous statements made by the Giovannini Group, according to which accounts should establish and provide evidence of proprietary rights in securities. More specifically “a transfer of legal title or pledge should be evidenced by book-entry in the respective accounts or through other appropriate measures such as earmarking procedures on the intermediaries’ accounts.”²⁷

It is noted that under a functional approach, the reference to “constituting evidence” may be misleading, since current domestic laws may either stipulate that a book-entry is constitutive for the acquisition or disposal of title, or that it merely has an evidential function, recording an entitlement that has already been acquired (and thus might be subject to counter-evidence that the entitlement has not been acquired which may give raise to concerns about the position of a third party relying on the credit).

1.7.1.3. Effect of validity

If a book-entry is the main constitutive element of the establishment of book-entry rights, there is no need to distinguish between effects between the parties (“validity between the parties” according to LCG-6 sect. 1)e)) and towards third parties (“effectiveness against third parties”), since a valid book-entry would have effect against anybody.

It is suggested to clarify that the concept of “validity” would extend to both credit and debit entries. This would be in line with Article 7(3) and (4) of the UNIDROIT draft Convention, which attributes legal effects to debits as well as o credits.

Furthermore, it should be considered to state explicitly in the 2007 Advice that a valid book-entry is to be considered legally binding and enforceable (thus conveying a “final” legal position on the account holder). The validity of a book-entry would, however, be subject to the principles established in this assessment regarding invalidity and its effects, certain rules of insolvency law and be without limitation to the transferors right to re-claim securities under contract law.

²⁷ Second Report on EU cross-border clearing and settlement arrangements, p. 15.

1.7.1.4. Invalid book-entries

The 2006 Advice (point 5.7) further states: *“Book-entry rights will not arise if the book entry is invalid.”*

This sentence is introducing a concept of “validity” of book-entries as a constitutive element for the establishment of book-entry rights. It further seems to imply that there is a distinction between a valid and an invalid book-entry, without specifying whether a “credit” in the meaning of the first sentence may be constituted only by a valid book-entry or by any book-entry.

It is suggested that the Advice establishes that a book-entry results in a valid credit subject to the provisions regarding invalidity and its effects (ex tunc or ex nunc, as the case may be, see below) or the application of certain rules of insolvency law.

In this assessment, no specific distinction is made between the terms “reversal” and “voidance”. From a functional point of view, a distinction can be drawn between the effects of an invalidity of a book-entry having ex-nunc effect or having ex-tunc effect. The latter can be described as “voidance of a book-entry” or “reversal with ex-tunc effect” indiscriminately.

1.7.1.5. Reasons for invalidity

The 2006 Advice (point 5.7) further states: *“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.”*

- Lack of instruction/authorisation

Contrary to the statement in LCG-6 sect. 1) e) regarding the UNIDROIT draft Convention (*“issues of validity etc. are exclusively determined by the domestic law, cf. Article 11(2).”*), Article 11(1) of the UNIDROIT draft Convention prescribes one harmonised case of invalidity, i.e. the lack of a valid instruction/authorisation of the intermediary:

“A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not authorised to make that debit or designating entry:

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to an interest granted under Article 8, by the person to whom that interest is granted; or

(b) by the non-Convention law”.

- Example 1: Credit did occur, but the underlying instruction/authorisation was invalid or did not exist at all.

It is noted that the 2006 Advice does not contain a rule for the invalidity of a credit in the absence of a valid instruction/authorisation.

It is felt appropriate that the 2007 Advice should also reflect this principle.

- Underlying obligation

Further, the 2007 Advice should clearly specify that the rules regarding the validity of book-entries are distinct from the underlying (contractual) relationship between the parties to a transaction or between an account holder and its intermediary.

- Example 2: Contract gave rise to a credit, but the contract was invalid under contract law.

It is submitted that validity of the credit should not be dependent on defects of the underlying obligation. Third parties acting in good faith should be able to rely on a credit.

An intermediary should not be obliged to reverse or cancel a credit or debit based on invalidity of the underlying contract between the transferor (the person whose account was debited) and the transferee (the person whose account was credited). An intermediary should only be obliged to reverse a credit (or block an account) if instructed by the transferee or a court.

This is without prejudice to a transferor being able to ask for re-transfer (i.e. a new debit and credit) based on invalidity of contract, which right should not be limited in time (except by national law on prescription), however, dispossession or good-faith rules may apply.

- Conditions

If national maintain a linkage of the validity of a book-entry to factors external to the account, the book-entry will have to be made conditional/contingent upon the fulfilment of these conditions. A key element will be transparency of the conditionality/blocking of the book-entry.

- Example 3: Under the law of country X, the validity of book-entries is *dependent* on a validly concluded contract between transferor and transferee.

If such national rules will be preserved, the book-entry will have to be made conditional/contingent upon the fulfilment of these conditions. A key element will be transparency of the conditionality/blocking of the book-entry (see below).

- Example 4: Under the law of country X, the validity of book-entries is *dependent* on validly established positions at the upper tier.

Again, if such national rules will be preserved, the book-entry will have to be made conditional/contingent upon the fulfilment of these conditions. A key element will be transparency of the conditionality/blocking of the book-entry (see below).

- Example 5: A credit was made by intermediary, but the account holder never paid the intermediary for securities.

If the validity of book-entries is *dependent* on fulfilment of a payment obligation, the book-entry will have to be conditional/contingent upon the fulfilment of these conditions.

A key element will be transparency of the conditionality/blocking of the book-entry (see below).

An issue to be further considered is the treatment of a legal regime relying on matching correspondent (simultaneous) credits and debits.

- DvP

Specific considerations should be given to facilitate DvP arrangements. Possible options would be (i) to make DvP related book-entries conditional, (ii) to block book-entries on the securities account or (iii) to prescribe that the securities leg is either settled only parallel or later than the cash leg.

- Example 6: A credit of securities is linked by way of a DvP arrangement to a corresponding cash payment.

DvP arrangements differ from jurisdiction to jurisdiction. Therefore, different alternatives to permit DvP could be envisaged:

- to make the book-entries conditional on fulfilment of the correspondent payment obligation,
- to block book-entries on the securities account or
- to prescribe that the securities leg is either settled only parallel or later than the cash leg.

A key element will be transparency of the conditionality/blocking of the book-entry (see below).

1.7.1.6. Reversals/Voidance

The intermediary should be allowed to re-debit (“reverse”) the credit under certain specified circumstances such as invalidity of a credit or erroneous booking.

It is noted that the 2006 Advice does not contain a rule permitting reversal in the absence of a valid instruction/authorisation. It is felt appropriate that the 2007 Advice should permit a right of reversal in case of invalid book-entries, subject to the protection of third parties, having acquired in good-faith. Whether the direct recipient of the credit should be protected if he has not engaged in any onward transaction is a matter for further consideration in the context of the formulation of the good-faith protection provision.

- Example 7: Credit did occur based on an error of the intermediary.

It is noted that the 2006 Advice does not contain a rule permitting reversal in cases of erroneous bookings. It is felt appropriate that the 2007 Advice should permit a right of reversal by the intermediary, subject to the protection of third parties, having acquired in good-faith. Whether the direct recipient of the credit should be protected if he has not engaged in any onward transaction is a matter for further consideration in the context of the formulation of the good-faith protection provision.

1.7.1.7. Effect of invalidity, reversal and voidance

The 2006 Advice (point 5.7) states: *“The maximum period of time during which a book entry may be invalidated is a matter for policy-makers to decide.”*

Following the considerations made in respect of reversals above, it is submitted that the only time limitation to reversals should be the restraints set by the application of the good-faith protection principles.

If reasons for invalidity exists or a reversal is made, it must be decided if the reversal takes effect from when it is made or already from the time when the invalid book entry was made (ex nunc or ex tunc).

It may not be possible to establish only one principle to apply to all cases, however, preference should be given to an ex tunc effect (see the principles below).

h) As a starting point, the following principles are being suggested:

A book-entry is considered valid and proving rights erga omnes (and not just providing evidence thereof), unless a reason for invalidity applies, in which case it may be reversed without the consent if the account holder.

- If the book-entry to the account was made in error by the intermediary, the intermediary may – with ex tunc effect – reverse the entry, unless a third party acting in good faith has acquired an interest in the credit position.
- If the contract that gave raise to the book-entry was invalid under the law governing the contract, the intermediary may (possibly only if the invalidity is established by a court order) reverse the entry – with ex tunc effect - unless a third party acting in good faith has acquired an interest in the credit position.
- If the credit was made conditional (e.g. of payment to the intermediary) and the condition is can no longer be met, the intermediary may re-debit the account – with ex tunc effect (regardless of any acquisitions that occurred after the conditional credit was made) - if it is apparent from the account that the credit was conditional. If it is not apparent from the account that the credit was conditional, the intermediary may still debit the account if the condition is not met, but only with ex nunc effect, so in practice the re-debit cannot be made if – before the debit - a third party acting in good faith has acquired an interest in the credit position or if the account holder has become insolvent and the securities have become part of the insolvency estate.

It is still to be further discussed whether there is a need for uniform rules on the time of which reversal takes effect.

1.7.1.8. Transparency of conditional/blocked book-entries

As elaborated above, where the validity of a book-entry is either conditional on the fulfilment of external factors or where book-entries are blocked on the securities account, it is proposed to provide for an explicit provision in the 2007 Advice that such conditionality or blocking should be made transparent, further expanding on what is contained in point 5.8 of the 2006 Advice : *“Where Member States ... allow 'uncovered' or 'conditional' settlement, this fact must be made clear to account holders, so as to provide transparency across the single market.”* In this respect, not only the fact should

be transparent, but it should also be easily ascertainable what the nature of the condition is and when it is usually fulfilled. Further action by intermediaries regarding transparency could then be limited to cases where the condition is unusually not met.

Such a transparency mechanism should on the one side ensure adequate information and protection of the account holder itself, but also of third parties, on the status of the account holder's positions/holdings. At the same time, it would allow to place public trust (inclusive possible good-faith effects) in the fact that a book-entry that has not been designated as being conditional or blocked is fully valid (and "final").

It remains to be seen whether there is a need to provide for harmonised rules regarding the mechanisms to ensure transparency, but since the principles of the Legal Certainty Group's Advice give predominance to entries on an account, preference should be given to mechanism relying on book-entries to disclose conditional or blocked credits or debits.

1.7.2. *Connection to insolvency law*

"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." , cf. 2007 Advice 5.6.

The overarching general principle that book-entry rights should be immune from the effects of insolvency of an account provider should be confirmed by the 2007 Advice. In case of an intermediary insolvency, the customers' assets (including those held at an upper-tier) are not part of the insolvency estate. In case of an incurable shortfall of securities (typically as a result of fraud by an insolvent intermediary) this should result in a pro rata deduction of the credits of the customers holding the types of securities that are in shortfall.

- Example 8: In the event of an intermediary's insolvency, the application of zero-hour rules is invoked to invalidate credits or debits.

The 2007 Advice should expressly confirm that no zero-hour rules applied to book entry rights in case of an intermediary insolvency. This rule should apply to all book-entries whether or not they are valid or can be subject to a reversal.

- Example 9: In the event of an intermediary's insolvency, the application of stays is invoked in respect of credits or debits.

In case of insolvency of the account provider, no stays should apply in respect of book-entries, including to interests in an account (e.g. pledge). This rule should apply to valid book-entries and to conditional book-entries, to the extent that the condition is not subject to an action by the account provider.

- Example 10: In the event of an intermediary's insolvency, the application of avoidance rules are invoked to invalidate credits or debits for the mere fact that they have been made during a suspect period.

In case of insolvency of the account provider, no avoidance rules should apply in respect of book-entries, including to interests in an account (e.g. pledge) for the mere fact that they have been made during a suspect period.

Further consideration should be given, however, whether some limited exceptions should be permitted to the overarching principle stated above. Similar exceptions are e.g. foreseen in Article 8(4) of the Financial Collateral Directive, which states that “...*this Directive leaves unaffected the general rules of national insolvency law in relation to the avoidance of transactions entered into during the prescribed period referred to in paragraph 1(b) and in paragraph 3(i).*”

- Example 11: In the event of an intermediary’s insolvency, the application of avoidance rules are invoked to invalidate credits or debits for reasons of fraud.

It is suggested that the application of general rules of national insolvency law in relation to the avoidance of transactions other than for the mere fact that they have been made during a suspect period should be maintained.

1.7.3. Establishing criteria for the above

“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.”, cf. 2007 Advice 5.7

This statement should be revised in line with the decisions of the LCG as regards the further specifications suggested under 2. above.

1.7.4. Develop interface to national law regarding this issue

It is suggested that national law should be decisive in all matters not explicitly dealt with under a) and b).

Community law should only provide for harmonisation to the extent necessary. As a starting assumption, the “interface” could be a general provision stating that in the absence of a harmonised provision in Community law, national law would remain applicable.

1.8. Integrity of the system²⁸

1.8.1. Background

1.8.1.1. Definition of "integrity"

While everybody seems to agree that the “Integrity of the System” is an important issue, to our knowledge so far no one has defined what that term does in fact mean. The authors, therefore, had to decide what constituted the integrity of the system. We came to the conclusion that – in our eyes – the term means that at no level in the holding chain

[²⁸ Chapter by Olaf Christmann and Ignacio Gomez Sancha]

more securities are validly credited than issued. Or, even more stringent, that no intermediary credits more securities to its customer accounts than it holds for customers directly (like e.g. CSDs) or with its next-in-tier-intermediary, irrespective of whether a breach of that obligation leads to a situation that more securities are validly credited than issued.²⁹

1.8.1.2. Various approaches to guarantee integrity

Everybody agrees that the issue is important, and therefore numerous solutions were proposed to avoid or correct such a situation, c.f. August Advice of the LCG:

- i. “In order to preserve book-entry rights, the duties of the account provider must be at least as follows: (5.9.1.) to maintain holdings matching the balance of credits on its account holder's accounts”
- ii. “...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.”
- iii. “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.”
- iv. “The Unidroit draft Convention, in its Article 22, provides for default rules regarding the sharing of a shortfall in securities in the scenario of the insolvency of the intermediary but leaves the decision entirely to the non-Convention law or, if so provided, to the rules of a settlement system. The LCG discussed the issue of whether future EU legislation should include a harmonised rule in this respect. The 2006 Advice clearly required a political decision in this regard. However, the LCG agrees that the issue should be elaborated further.”
- v. “The Unidroit draft leaves in its Article 21(3) the methods of allocation of securities to clients (including by means of segregation) to domestic law. The issue is briefly addressed in the 2006 Advice, section 5.2.9.5. The LCG acknowledged that allocation/segregation is an issue of huge importance and that it is particularly highlighted in the context of investor protection.

²⁹ Since this definition sets out the parameters of the subsequent analysis, we would be very interested whether the other members of the group share our view of the problem.

The LCG will have close regard to MiFID Article 13(7) and MiFID Implementing Directive Article 16(1)(d) where identification (= segregation?) is established as a requirement for investor protection.”

As can be seen, numerous solutions are being offered. However, we feel that since the term “integrity of the system” has never been defined, the answers were given somewhat in the dark. We further are of the opinion that the proposed solutions are somewhat generalising in nature and not taking into account the diversity of possible scenarios and how to address them.

1.8.1.3. Leading questions towards the right solution

The following questions have to be asked:

- i. What are situations that can actually adversely affect the integrity of the system?
 1. A diminishing (in the fungible pool) of securities held at CSD (or other level to the extent foreseen by national law) level?
 2. An erroneous (non-)booking (possibly coupled with good faith)?
 3. Would such erroneous booking matter anywhere in the holding chain?
- ii. It appears to be safe to say, that any diminishing of securities held at CSD-level (whether by a diminishing of the fungible pool or – where such pool does not exist – by having more securities credited than issued for whatever reason) would lead to a situation where more securities have been validly credited than issued. Even in a system where the investor does not have any right with regard to that pool (e.g. where he derives his right solely from his next-in-line intermediary), the imbalance would be with the CSD’s next-in-line intermediary. The imbalance would cascade downwards from there, finally reaching the investor.
- iii. However, whether an erroneous booking in other places of the holding chain would create such an imbalance depends to a large degree on the underlying nature of the asset, the legal relationship of the investor toward the asset and the manner in which the asset/relationship is transferred, which in turn determines whether all, some or only one of the book entries in the chain are legally relevant. We could come up with three principle scenarios³⁰:
 1. “Ownership” of the asset is transferred from buyer to seller and the intermediary is never entitled to the asset but merely transfers

³⁰ We tried to come up with “rough” classifications, any input of colleagues on their system would be highly appreciated

“ownership”³¹, or “possession”³² or something similar or altogether different³³;

2. [“Ownership” of the asset is not transferred from buyer to seller; instead the interest of the seller is “cancelled” and a new interest of the buyer is “created”; this is usually coupled with a system, where the investor does not per se have an interest in an underlying pool of securities but where his interest is derived from his next-in-line intermediary.]³⁴
3. “Ownership” of the asset is transferred from seller to buyer, but not directly, but it is passed on in the intermediary chain and intermediaries become entitled to the transferred asset for a short period in time. Two possible permutations of this scenario exist, in that the intermediary is required to either
 - pass such entitlement onward completely in the holding chain until it reaches its final destination; or
 - to pass on “a large portion” of such entitlement, keeping a “little something” for themselves³⁵.

1.8.1.4. Various means to avoid imbalances at disposal

What means are there to avoid an imbalance between securities credited and securities issued under the different scenarios?

- i. Applying the “No credit without debit”-principle (= tracing). The name of this principle is somewhat misleading. It appears to be a mere accounting tool (and to our knowledge it is a requirement for intermediaries on an accounting level), but it is also used to describe a substantive system for the transfer of securities where “ownership” (or the asset or the interest in the asset) is transferred from seller to buyer (either directly or via multiple transfers in the holding chain, see above) and no-one acquires something unless someone else loses something in the same amount. That means that if buyer A receives a valid credit for X securities, there has to be a corresponding debit of X securities from the account of a seller (or sellers). While it might be technically simpler to apply this principle in a situation where both seller and buyer have their accounts with the same intermediary, in countries where this principle is already applicable it does not stop there but is applicable to all securities transactions, even if it

³¹ Like in Japan.

³² Like in Germany under the concept of “GS-Verwahrung”.

³³ Like in [??].

³⁴ US model, don't know if anyone in the EU does it like that and if we should list it at all.

³⁵ Like in the UK or in Germany with regard to securities held under the concept of “Wertpapierrechnung” where the legal ownership remains with the intermediary and only commercial ownership is passed on to the customer.

might be (technically) difficult to identify seller and buyer to a certain transaction.

Logically, this principle could also be applied in cases where the interest is passed onward in the chain of holding, requiring the intermediary to at all times maintain sufficient cover with the upper-tier intermediary (in such systems, this requirement goes beyond a mere accounting requirement) and giving substantive effect to any breach of that requirement, i.e. where the intermediary violates this requirement, the next-in-line person does not receive any interest.

- ii. Conditional Bookings: The practice of conditional bookings is mindful to the fact that in commercial practice bookings are effected before all requirements for the acquisition of the asset (or interest therein) have been fulfilled, whether this requirement is that the interest of the seller is validly extinguished or that the intermediary has yet to receive something that it can pass on along the chain of holding. By making a booking conditional, a legal systems safeguards that not every “out of the line”-booking immediately leads to a situation where more securities are validly credited than issued.
- iii. Sensible use of a good faith rule: By “sensible” we mean a good faith rule that links a good faith acquisition of a purchaser to the loss of interest of some other party; i.e. that the acquisition of one investor has to be to the detriment of someone else. Having such a rule complements the “no credit without debit”-principle in that it ensures that any acquisition is legally connected to a corresponding loss of interest. A good faith rule that only looks at the acquisition side without requiring that such acquisition is accompanied by a corresponding loss would be an “unsensible rule”, since such a rule has the potential to adversely affect the integrity of the system as more securities are validly credited than issued, requiring the situation to be rectified.

1.8.1.5. Means to rectify unavoidable imbalances

In our opinion, a legal system should strive to avoid any imbalances to the extent possible by the above described means. However, in legal systems and/or situations where such a situation cannot be avoided (e.g. customer was in good faith and a jurisdiction does not have the credit without debit requirement), there have to be means to rectify such situation.

- i. Reverse bookings for erroneous bookings - A reverse booking is only then a tool to rectify an imbalance where such imbalance can be caused by an erroneous booking, either because even such a booking has per se substantive effects or possibly coupled with a purchase in good faith (where the acquisition is not to the detriment of a third party). Under any other circumstances, where no title is transferred by the erroneous booking, the integrity of the issue is not affected and a reverse booking merely has a formal/accounting nature.
- ii. Intermediary has to buy in – As with reverse bookings, two permutations are possible. Either, the credit was not (yet) valid, then the integrity of the issue is not affected and the intermediary has to buy in to fulfil its contract vis-à-vis the investor. Or, the credit did have substantive effect and the intermediary

does not hold sufficient securities with his upper-tier-intermediary, the intermediary has to buy-in securities to cancel out the imbalance³⁶.

- iii. If buy-in fails³⁷ – Intermediary uses its own securities to rectify imbalance. As under ii., this might either be in the fulfilment of contract (if the credit had no substantive effect) or (if the credit was valid) to balance out the amount of credits with the amount of the issue.
- iv. If all of the above fails³⁸ - Application of a loss sharing mechanism, possibly restricted to cases where the intermediary is insolvent. This poses a much discussed policy question – Should all suffer a little or one suffer a lot. Most of the means to rectify an imbalance involve some sort of loss sharing. In a “connected good faith rule” it is solely the “seller” that suffered the loss³⁹. In cases where the credit was not valid, the buyer suffers the loss, since he only has a claim against the insolvency estate⁴⁰. While these situations might not be considered to be “true loss-sharing cases” in cases of “true loss sharing” the question arises whether all customers of the intermediary that have securities of the same issue should share or – going beyond that – if all customers of same intermediary should share (irrespective of whether the hold securities of the same issue)⁴¹ or if only such customers should share that have their securities commingled in an omnibus account at the upper-tier intermediary (therefore excluding customers whose securities are held on a segregated basis at the upper tier intermediary).

1.8.1.6. Role of segregation

We think that when talking about segregation, one has to mean “segregation at the level of the upper tier intermediary”, not at the level of the relevant intermediary, where such segregation might also be warranted for accounting purposes, but seems to have no substantive effect. Having said that, segregation has basically nothing to do with the integrity of the system. A means to segregate clients assets from the intermediaries assets to assist re-vindication in an insolvency situation⁴² and to make clear that they are not

³⁶ Interestingly, the way this happens is that once the intermediary has bought the “missing” securities and they are delivered to him, they cease to exist.

³⁷ We are unsure whether such sequencing, as it appears in the UNIDROIT draft, does exist today in legal regimes that contain such an obligation of the intermediary or if it is left up to the intermediary if he would rather buy in or use its own assets.

³⁸ Again, we have a sequencing that might not be adequate for all situations. Where the fungible pool is diminished, it makes little sense to require the CSD to buy in or to use own securities.

³⁹ Possibly (and in our minds in such a situation probably) the “seller” will have a claim for damages against his intermediary in a case like this. His “property” is nonetheless gone.

⁴⁰ Which might be granted preferential treatment, e.g. sect. 32 of the German Safe Custody Act.

⁴¹ A solution that was once proposed during the UNIDROIT negotiations.

⁴² Art. 13 (7) MiFID: “An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent.”

part of the insolvency estate of the intermediary⁴³. Segregation only has a further substantive meaning only if specifically attributed to it (c.f. d. above). This does not at all mean that a segregation requirement could not be a useful tool when protecting the integrity of the issue⁴⁴. However, segregation itself will not have that substantive effect but only when coupled with the substantive solutions described above.

1.8.2. *Proposed solution – is legal action required?*

The analysis of the questionnaire has not given any indication that one particular national rule with regard to the protection of the integrity of the issue gave rise to particular legal concerns. The analysis of the questionnaire has also shown that different legislations use different means to avoid and/or rectify situations that adversely affect the integrity of the issue. The majority of the group has nevertheless concluded that the diversity of the existing rules is a problem in itself. We therefore asked the question whether there could and should be “One Rule to Rule All”-rule that protects the integrity of the issue in every legal system. Generally speaking, we would find it preferable if a legal system were to avoid imbalances between the amount validly credited and the amount issued, since any imbalance persists at least for some time raising questions that we think should better be avoided in the first place⁴⁵. However, we are aware that situations exist where it is impossible to avoid such an imbalance⁴⁶, where it might be necessary to cure such an imbalance retrospectively. Having said that, we were unsure whether such “One Rule” exist and/or would work in the different legal environments. Some rules are an adequate method under some legal systems, while they would have no (beneficial) effect (at least for the problem at hand) in other legal systems.

In the following, we have assessed whether the LCG should propose legal action with regard to any of the methods identified above to safeguard the integrity of the system.

1.8.2.1. “No credit without debit”

A direct transfer of “ownership” (i.e. seller transfers ownership to the buyer) might be seen as the most stringent form to protect the integrity of the issue. There are **never** more securities validly credited than issued (unless the fungible pool of securities at CSD-level is reduced).

Legal recommendation in that sense? Arguments?

- i. Touches on MS civil law concepts (no mandate of the group)
- ii. Touches on the question “nature of entitlement” (group wants to be neutral on that topic)

⁴³ Art. 21 (3) of draft UNIDROIT-Convention: “Subject to Article 14, securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary.”

⁴⁴ If all accounts were segregated until CSD-level, the application of the “no credit without debit”-rule would be largely facilitated in its practical application.

⁴⁵ Dividend payments/voting rights in the amount credited or issued.

⁴⁶ As has been mentioned, a fire or theft in the vault of a CSD might be one such case.

iii. Touches on the technical manner settlement is performed in different countries⁴⁷

1.8.2.2. Use of conditional bookings

A means to safeguard that all other requirements in the holding chain are fulfilled before buyer acquires a valid interest; can therefore also be seen as a safeguard that buyer does not acquire before the integrity of the system (= issue) has been considered.

Legal recommendation in that sense? Arguments?

- i. the admissibility of conditional bookings might touch on the public policy of some MS;
- ii. MS might have come up with solutions where conditional bookings are not necessary, e.g. F, where the final booking on the investor account may only be made once all other pre-requisites in the chain have been fulfilled.
- iii. [MS might have a legal system in place, where every credit transfers “ownership rights” to the account holder so that conditional bookings are unnecessary].

1.8.2.3. Reverse bookings for erroneous bookings

To our knowledge common legal standard in all MS, legal action therefore not required; however, in two possible permutations:

- i. A validly created interest is revoked by the reverse booking;
- ii. No valid interest was created by the erroneous booking and reverse booking therefore has no substantive effect, mere accounting measure

Legal Recommendation in that sense Probably unnecessary since existent in all MS anyhow (has to be checked)

1.8.2.4. Buy in of “missing securities”

To the extent this requirement is not already contained in national legislation, this would constitute a reasonable addition. Again, as mentioned above, two permutations:

- i. If book entry in itself (or possibly in conjunction with a good faith acquisition w/o corresponding debit) created an interest in securities, buy-in rectifies an imbalance between securities credited and securities issues.
- ii. If no right was created, buy-in is a means of the intermediary to fulfil its obligation vis-à-vis its customer.

⁴⁷ Direct transfer of ownership works best in a system, where all investors have their accounts with a CSD, like Scandinavia or China, unsure whether the group should only propose legal changes or if it could go further and state that the legal problems are to a large degree caused by intermediated holding as such

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- iii. Therefore, the requirement to buy-in should not be subject to contractual agreement among parties; however such requirement might be limited by the laws of a MS if the intermediary is not at fault (c.f. v. below)⁴⁸.
 - iv. However, requirement to buy-in does not pre-judge the question who has to bear the cost; intermediary should only bear the cost if the under-coverage was “his fault”; if not, seek indemnification from the one who is at fault. Who should seek indemnification? The one who chose the institution at fault.
 - v. Alternative: requirement to buy in only if the under-coverage was the intermediaries fault;

1.8.2.5. Drawing on the own funds of the intermediary

This method seems to be less common in MS legal systems, might nevertheless be a worthwhile addition. As with regard to buy-in, two permutations:

- i. In case an interest of the account holder was validly created, a means to cure an imbalance between the amount of securities issued and the amount of securities validly credited;
- ii. In case not valid interest of the account holder was created, a means to comply with the contractual obligation vis-à-vis the customer;
- iii. Also as above, the requirement would not pre-empt the question of who has to bear the cost;
- iv. Possible alternative: requirement to draw on own funds only if the under-coverage is the fault of the intermediary;
- v. Also, UNIDROIT-Convention has to be observed. Requirement to draw on own funds is laid down in Art. Xx and might therefore be introduced anyhow. However, contracting States have the possibility to declare that in case of segregation of own funds from customer funds at the upper-tier intermediary such requirement would not exist. A decision whether (some or all of the) EU-MS would make use of that provision has to be taken.

1.8.2.6. (Pro-rata) loss sharing

Where a shortfall is conceptually possible and no other means to cure such shortfall exists, a loss-sharing provision might be seen as an adequate manner to cure a shortfall. But: No proposal to make such a provision mandatory in every MS, since

⁴⁸ See Art. 20 of the UNIDROIT-Convention “The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system.”

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- i. in many MS shortfalls are dealt with (or avoided in the first place) in a different and altogether acceptable manner;
 - ii. it touches on the core of what national laws deem to be a “just result”;
 - iii. the Group has already decided that this was a “political decision”⁴⁹.

1.9. Holding through intermediaries⁵⁰

1.9.1. Allowing intermediation

Article 26 of the revised draft of the proposed Preliminary Draft Convention On Substantive Rules Regarding Intermediated Securities (the “Unidroit Draft Convention”) provides that

“The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise in accordance with Article 7 of the rights attached to such securities which are so held, ...”

The first part of this provision does not seem to be addressed by the LCG Advice but this is implicit as this is at the very heart of the advice.

The second part of this provision is, however, addressed as the principles set forth in Article 7 of the Unidroit Draft Convention do correspond in essence to Section 5.2.11 and 5.2.1.2 of the LCG Advice.

Article 7 is, however, more specific than the corresponding LCG Advice as its scope in Article 7(1) refers to circumstances where the accountholder is not an intermediary or is an intermediary acting for own account. It further makes reference, however, to any other case provided by non-conventional law.

Section 5.2.1.3 does not seem, however, to be the exact equivalent of Article 7 1 (b) of the Unidroit Draft Convention as that Article does not incorporate the concept enshrined in the LCG Advice that the intermediate is expected only to facilitate the exercise of rights of accountholders (including corporate rights) in respect of intermediated securities. The provisions of Article 7 (2)(b) of the Unidroit Draft Convention seem, however, to cover the LCG Advice and there may therefore be an inconsistency in the Unidroit Draft Convention in this respect. LCG 7, which identified that issue took the view that Section 5.2.1.3 probably does reflect the reasoning of the Unidroit Draft Convention. This matter may need to be revisited.

⁴⁹ In that context, we don’t even think that it is a political decision. It is simply not required as MS have created different means to cure shortfalls. Some have tried to prevent shortfalls in the first place, others accept shortfalls as an economic (and legal) fact and concentrate on curing it in the context of which a pro-rate loss sharing provision might be seen a good idea.

[⁵⁰ The background note was prepared by Antoine Maffei.]

Therefore consideration may need to be given to clarify that provision of the Unidroit Draft Convention as the wording of Section 5.2.1.3 is a key concept for those legal systems which do provide for a direct legal relationship between investor and issuer.

A review of the Group's Compendium (Question 3) shows that each Member State securities law system in fashion or the other does contemplate the existence of securities accounts held through intermediaries although the characterisation of the holding pattern of a securities account may vary.

Few countries seem to have defined the concept of securities account and some contemplate securities accounts held with CSD but this may be due to specificities of transparent systems, in particular in some Nordic countries.

Therefore, there seems to be no need to consider defining the concept of Securities Account as each legal regime seems to have incorporated that concept in its system at least from a practical perspective.

One matter may merit, however, further consideration. Article 26 (1) of the Unidroit Draft Convention seems to be restricted in scope as it applies to securities traded on a exchange or on a regulated market. The question is whether this is the intent of the Group to have such restrictive approach. This is perhaps also a policy issue to be considered by policymakers in the context of wider use of dematerialised securities particularly in the context of MIFID and the multilateral trading facilities contemplated thereunder.

In view of the importance of that concept there may be merit to consider incorporating in the LCG Advice a provision similar to Article 26 of the Unidroit Draft Convention. Some further thought would then need to be given to the scope of that provision.

1.9.2. Holding in Own Name for the account of another person- Interconnectivity of systems

Article 26(2) provides that the law of a Contracting State shall recognise the holding of securities by a person acting in his own name on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description.

Among the core provisions of the LCG Advice Section 5.1.2 thereof contemplates that nothing in the new legislation should prohibit or impede any market practice for holding securities, such as direct holding by the accountholder with the issuer, both with an without account providers at the intermediary level, holding securities in a pool, or holding through individually segregated accounts.

It is further contemplated in Section 5.1.3. of the LCG Advice that the new legislation should 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.

The LCG Compendium (Question 6) shows that although most countries do recognise this type of holding pattern some countries show a more reserved approach towards that holding pattern if not non-recognition. Those countries represent, however, an exception but in some countries this may be prompted by tax considerations.

Article 24(2) of the Unidroit Draft Convention does, however, clearly recognise the obligation of Contracting States to recognise the holding of securities by a person acting in its own name on behalf of another person or other persons. It is further contemplated in that Article that in the context of such holding pattern the right of an intermediary to exercise voting or other rights in different ways is to be expressly recognised. It is, however, specified that the Unidroit Draft Convention does not specify the way in which such an intermediary is authorised to exercise such right.

Furthermore, Article 13 of the SRD and in particular Article 13(5) thereof seem to address that issue where it is stated that where applicable law limits the number of persons whom a shareholder may appoint as proxy holder, such limitation must not prevent a shareholder from granting a proxy to every one of his clients or to any third party designated by a client.

It is further stated in Article 13(2) that where applicable law imposes disclosure requirements as a prerequisite for the exercise of voting rights by a shareholder, such requirements shall not go beyond a list disclosing to the company the identity of each client and the number of shares voted on his behalf.

It should be noted that the SRD defines as a Shareholder a natural or legal person who is recognised as shareholder by the applicable law.

Document LCG 11 recognises that while this issue is important as there are Member States where such holding pattern is expressly forbidden, that issue is within the purview of a policy decision and need therefore to be addressed as such. The paper further concluded that instead of trying to eliminate such rules, the LCG Advice should emphasise the effect of a book entry which would always grant the minimum rights as set out in the LCG Advice even in circumstances where the above mentioned holding pattern appeared in the holding chain. Reliance on Article 13 of the SRD was highlighted in this respect as partly addressing that issue.

The document therefore concluded that as no clear result could be achieved on that issue, it should be illustrated in the future LCG Advice leaving any further decision to policy makers.

1.9.3. Exercise of corporate rights attached to securities

As a preliminary remark it should be noted that there may be overlap in respect of this question with the Group's Strand 2–Subject 2 corporate action processing. Some aspects of this question may also be addressed by Topic 2 of Strand 1 i.e. “The accountholder-provider relationship”.

Sections 5.2.1.3 and 5.2.1.4 LCG Advice address this question in terms of a two flow approach i.e.:

(a) Bottom-up

Facilitating exercise of rights of accountholders in respect of securities to which book-entries relate through instruction (general or specific) to the account provider including:

- right to vote,
- right to receive dividends income capital,
- right to subscribe for further securities,
- right to consider takeover offers and other corporate events.

(b) Top-down

Receipt of corporate information communicated to the account provider in that capacity and relevant for the exercise of corporate rights and other rights.

That matter is also addressed by Sections 5.9.2 and 5.9.3 of the LCG Advice.

A thorough analysis of the issues raised in respect of this matter in the paper "Corporate Actions – Core Issues"⁵¹. It is not our intention to restate that paper to which we concur.

Participation in shareholder meetings and exercise of voting rights in respect of listed companies has been addressed by the SRD in much detail. However, the scope of the SRD is limited and the question is whether extending that scope need to be considered.

Use of intermediated securities is indeed not limited to listed securities and an extended use of intermediation is to be expected as market trends and new technology tend to develop recourse to intermediation.

Furthermore entry into effect of the MIFID Directive will probably have a similar effect in particular as a result of wider use of multilateral trading facilities and other internal systems.

As a preliminary remark in this respect one should emphasise that those issues are closely rooted in company law in respect of which the LCG has taken the view that it should remain untouched.

The aforementioned paper also emphasizes the cost element relating to extending the scope of the duties of the intermediary in this respect.

Finally it should be highlighted that facilitating exercise of those rights is highly dependent on the issuer. Passing down information is also highly dependent on technology and this may require that as a mitigant for the possible intermediary's liability (in particular as far as CSD's are concerned) information will need to follow specific format requirements such as specified SWIFT Codes or Forms as may be specified in Terms and conditions of the Intermediary or as recognised by market practice.

Finally different Rules may need to be specified in respect of registered shares as compared to bearer shares, the role of intermediaries being more limited in respect of registered shares where information is passed down directly by the issuer.

As suggested in the aforementioned paper a distinction should be made between those rights which require accountholder cooperation or instruction or those which do not.

Those which do not require such cooperation or instruction are collection of cash dividends and interest or other cash distribution of profits and assets. Bond redemptions may also be in that category. Other areas may include:

- exercise of subscription or exchange rights

⁵¹ Cf. Doc. LCG-9, Annex 1, prepared by Jürgen Than.

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- acceptance of take-over bid or other purchase offer.

where no personal action of the account holder is required.

Facilitating exercise of rights may include:

- exercise of voting rights or other rights in or with shareholders or bondholder meetings;
- exercise of reorganisation or restructuring process (with the provision that that process would only apply to the extent the account provider receives information from the issuer with instruction to pass down that information to relevant account holders. There should be no general obligation to advise bondholders of changes in status such as opening of insolvency proceedings filing of proof of claim without specific instruction from the issuer);
- exercise of rights in class actions or other legal proceedings;
- election in respect of subscription or allocation of bonus shares or sale or regrouping of odd shares (this matter being in some instances subject to corporate law restrictions);
- exercise of class actions or other legal proceedings;
- exercise of subscription or exchange rights;
- acceptance of take-over bid or other purchase offer;
- exercise of pre-emptive rights;
- conversion of convertible bonds or other securities;
- exercise of warrants;
- redemption of investment certificates;
- exchange of securities following mergers or acquisitions or spin-off's.

From a more general perspective, emphasis should be put on the requirement for the account provider to pass down information received and to request information upwards in the holding chain when a request is made by the account holder.

As a general matter, emphasis should be put on the fact that the account provider only acts on the basis of instructions of the account holder unless otherwise provided by contract, law or regulation.

From that perspective as contemplated in LCG 11 (par 18), there may be merit in further elaborating in the LCG Advice the rule incorporated in Article 20 of the Unidroit Draft Convention.

1.9.4. Corporate rights conferred upon intermediaries

Reference is made to paragraphs 1 and 2 above. This matter is addressed in Document LCG 6 in a manner which may appear somewhat inconsistent with Document LCG 11 (Paragraph 22 and also paragraph 2 above which reflect the approach taken in the Group's May meeting).

Document LCG 11 emphasized that eliminating rules inconsistent with the recognition of the principle allowing account providers acting for others to exercise rights on behalf of those others was within the scope of policy. Therefore, the better approach advocated was to emphasize the effect of a book entry which would always grant minimum rights

as set out in the LCG Advice, even in cases where the above mentioned holding pattern appeared in the holding chain.

Document LCG 6 stated that while the LCG Advice in its current 2006 version only touches on this matter peripherally in its sections 5.2.1.3 and 5.2.1.4, there is agreement within the LCG that the matter is central to its work on Subject 2 which seems indeed to be the case. It further stated the close connection of this matter with the SRD.

Without prejudice to the final outcome of this matter and in view of the limited scope of the SRD the better view may well be that the right approach in respect of this matter is most likely the one adopted in Article 7 of the Unidroit Draft Convention.

This is indeed a central issue to ensure interconnectivity and there is probably merit in stating or restating that rule in no unclear terms.

A possible approach may be to consider a rule focusing on the fact that in those countries where property laws provide that rights related to securities are exercised by the account holder who is not the intermediary or by the intermediary acting on own account, then that rule should prevail. However, for the sole purpose of ensuring interconnectivity national law will need to recognise the possibility for an intermediary to act for others and as a result to exercise rights for others.

This rule may be drafted in such a manner so as to emphasise the prevailing rule while recognising the legal effect of a book-entry as conferring rights related to the securities for the sole purpose of ensuring interconnectivity between systems.

This issue is indeed central to the LCG Advice and is also consistent with its spirit and with the SRD.

1.10. Attachments⁵²

1.10.1. Introduction / Delimitation

Whilst the prohibition of upper tier attachment and the prohibition of the attachment of segregated client accounts by creditors of the account provider both relate to “attachments” they deal in fact with two different issues.

The phrase “upper tier attachment” is commonly used to refer to the risk that a securities account with an account provider at a higher tier in the holding pattern may be subject to a legal claim (typically through court proceedings) to freeze or attach the account in order to enforce a claim against a person alleged to hold an interest through an account provider at a lower tier.

The prohibition is essentially designed to allow the unhampered use of “omnibus” accounts and to ensure the efficient operation of the indirect holding system. The implementation of this prohibition was advocated in the Giovannini II report of April

[⁵² The background note was prepared by Philippe Dupont and Ignacio Gomez-Sancha.]

2003 under the comments to Barrier 13 and is included in item 5.5 of the August 2006 Advice (the “Advice”) of the Legal Certainty Group (“LCG”).

The prohibition of the attachment of segregated client accounts by creditors of the account provider is a new idea which was briefly discussed during the last meeting of the LCG but which is not reflected in the Advice. The goal of this rule is to enhance investor protection and to allow for an efficient functioning of the indirect holding system.

For the above reasons the two issues will be dealt with in two separate chapters.

1.10.2. Prohibition of upper tier attachments

Section 5.5 of the Advice provides:

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.

This general principle may have to be nuanced when it comes to drafting a rule.

In truly indirect systems (opaque systems) the securities account holder may only exercise its rights in the securities held in a securities account against its own direct account provider. The account holder has no rights against the higher tier account provider. Hence there is nothing to attach at the higher tier account provider level. The taking up of an “upper tier prohibition rule” in these systems is thus merely stating the obvious and serves as a clarification.

In systems where the investor is considered to be the direct owner of the securities all the way down the holding chain upper tier attachment is conceivable.

Two scenarios must be distinguished:

- the investor, as owner of the securities, can only be identified as such by his own direct account provider, the higher tier account provider being unable to do so;
- the investor, as owner of the securities is identified / identifiable at the direct and at the higher tier account provider level.

Where higher tier identification is not possible the upper tier prohibition rule is important and adds actual legal value.

Where higher tier identification is possible a legal and a policy issue arises.

This issue, which applies with respect to so-called “transparent systems”, has been intensively discussed at Unidroit level (see especially Working Documents 43, 44, 60 and 70), and these discussions won’t be repeated in this document.

Some key elements are of importance and may need further discussions at the LCG:

- where the investor has a direct account relationship with the higher tier account provider, its direct account provider acting merely as an “account operator” there is no

issue of upper tier attachment because the investor holds no actual securities account with its direct account provider;

- where the direct account provider of the investor holds itself an account with the higher tier account provider which is subdivided in as many sub accounts as there are direct investors and the identity of the investors is disclosed to the higher tier account provider one may conceive an “upper tier attachment”. This depends however in particular on
 - the identification of the decisive record (direct account provider/higher tier account provider) of the investor’s rights
 - a solid information transfer system between the direct and the higher tier account provider to ensure that they receive the same information in real time.
- where a “two-tier centralized model” applies (i.e. an exchange of information system) the issues are probably identical to those described in ii) above.

In the above context the question arises whether “transparent systems” are transparent even for cross border holdings *i.e.* where the account provider of the investor is located in a country other than the transparent system country and such foreign account provider holds investor securities in its name with a higher tier local account provider. The answer to this question will determine whether or not upper tier attachment rules are relevant even for transparent systems.

A definition of “attachment” will need to be worked out . Inspiration could be drawn from the current text of Article 17 of the draft Unidroit Convention. An important question to resolve is whether criminal law based attachment orders should be subject to the same rules as civil law based attachments.

The current rule of the Unidroit text which attempts to account for transparent systems reads as follows:

Article 17 [Prohibition of upper-tier attachment]

1.- Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made against, or so as to affect –

- a) a securities account of any person other than that account holder;*
- b) the issuer of any securities credited to a securities account of that account holder; or*
- c) a person other than the account holder and the relevant intermediary.*

2.- In this Article “attachment of intermediated securities of an account holder” means any judicial, administrative or other act or process to freeze, restrict or impound intermediated securities of that account holder in order to enforce or satisfy a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of that account holder or in order to ensure the availability of such intermediated

securities to enforce or satisfy any future such judgment, award or decision.

3.- A Contracting State may declare that under its non-Convention law an attachment of intermediated securities of an account holder made against or so as to affect a person other than the relevant account provider has effect also against the relevant account provider. Any such declaration shall identify that other person by name or description and shall specify the time at which such an attachment becomes effective against the relevant intermediary.

1.10.3. Prohibition of attachments of segregated client accounts by creditors of the intermediary

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (“MiFID” – Articles 13.7 and 13.8) and level 2 Commission Directive 2006/73/EC of 10 August 2006 (Article 16.1.d) require that credit institutions and investment firms “*must take the necessary steps to ensure that any client financial instruments deposited with a third party (...) are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection.*”

This segregation rule is designed, according to MiFID, to safeguard client securities in case of insolvency of the direct account provider and to prevent the use by the account provider of client securities for own account.

The draft Unidroit Convention contains a more abstract rule in Article 19 which aims especially at the safeguarding of client assets rather than at the prevention of use of client securities.

In a truly indirect holding system investors would *e.g.* hold an account with account provider A who in turn would open in its name two financial instruments accounts with account provider B, one being identified as a “proprietary account” the other as a “client account”.

In case a creditor of account provider A wishes to attach account provider A’s assets he will seek an attachment order which will generally provide for the attachment of “all accounts opened in the name of account provider A”.

Faced with such an order account provider B will have to freeze both the proprietary and the client accounts of account provider A in its books, both accounts being opened in the name of account provider A albeit with different headings.

This will have as an effect that until the attachment order is released (which may take more or less time depending on local procedural rules) no transactions may be carried with the client securities.

This problem arises because, although MiFID provides for a segregation requirement, it does not draw any legal consequences from such requirement.

The idea could be to provide that creditors of an account provider may not attach accounts which are identified as “client accounts” with a higher tier account provider.

The term “attachment” will have to be defined (see point 15).

One may wish to consider the extension of the prohibition to any right of pledge, set-off or retention of the higher tier account provider with respect to the “client account”, except, may be, where claims of the higher tier account provider arise in the course of the operation of the “client account”.

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