

LCG Meeting 10/11 September 2007

Appendices 3-8
(Powerpoint presentations)

Appendix 3

Corporate Actions

LCG Subgroup 2 Work Overview

Investor-Issuer Relationship in Case of Intermediated Securities

- In the intermediated world, investors require certain assistance of the intermediaries to exercise the rights and enjoy the benefits vested in their securities
- The spectrum of activities/assistance by intermediaries:
 - Assistance in the evidencing and identification of the investor vis-à-vis the issuer, e.g. issuing a certificate for the investor which the investor can show to the issuer in order to be entered on a list of shareholders for a particular corporate event,
 - Providing for a channel of communication between the investor and the issuer (whether it is provided for partial or full-fledged communication, may vary from corporate event to corporate event)
 - The actual exercise of investor's rights, including the decision-making (esp. In legal systems which attribute the legal ownership of securities to the intermediary, rather than the investor)

- *The Focus*

- Legal obstacles to **cross-border** corporate actions processing

- So far, the LCG Questionnaire does not address the cross-border context

- *The Approach*

- **Subsidiarity and proportionality** of the legislative intervention at the EU level

The Key Issues

1. Choice of the method of identifying the person entitled to exercise corporate rights
2. The range of corporate actions available to that person, even in a cross-border holding scenario, needs to be identified and clarified
- Additional issues:
 3. Intermediaries' duties vs. Investor's rights
 4. Any other analysis needed to complete the scope of our work on Corporate Actions

1. The Person entitled to exercise the corporate rights

- Identification of that person on the basis of (national) corporate law? Better: Functional approach.
- Account holder?
- Person bearing the economic risk? „Who holds for own account“.
 - Approach of SRD, TransparencyD, Unidroit
 - Approach of the LCG Advice?
- How to term this person? „Investor“?

2. The Classification of Corporate Events

- *i. Distributions v. Reorganisations*
- *ii. Mandatory v. Voluntary*
- *iii. Transactions Management*
- *iv. General Meetings*

i. Distributions v. Reorganisations

Distributions

= “events where an issuer of a security delivers to a holder of those securities a particular benefit or “resource” (e.g. cash, securities, rights, etc) and where the underlying holding which gave rise to the distribution is unchanged by the event” .

The key element in the distribution definition is the fact that **the underlying holding and/or securities remain unchanged.**

Example: a cash dividend. In this event, the shareholder receives cash (or coupons until fully abolished) but his original shareholding is unaffected. Other types of distribution include for example interest payment.

Distributions can be mandatory or mandatory with options but cannot be voluntary.

Reorganisations

= “events where the issuer replaces a security with another resource. The issuer will deliver a benefit to a holder of the security affected by the corporate action. The holding in the original security will be removed from the account or become valueless as part of the event. For example, a security (A) is replaced by another security (B) or other resource (stock and /or cash)”.

The key element in the reorganisation definition is the fact that **the underlying holding and/or securities is affected by the event.**

Examples: merger, takeover bid, etc.

ii. Voluntary v. Mandatory Events

Voluntary events: “events in which holders of a security need to act if the event is to affect their holdings. The issuing company will usually inform all holders of the event that is about to take place; sometimes this notice is provided in the original offering documentation for the security. If no action is taken by the holder then his holding will be unaffected by the event”.

Mandatory events: “events that will occur without any action required by individual holders of the security. They may involve, for example, an issue of securities, a reorganisation (i.e. mandatory exchange) or certain payments”.

Mandatory events with options: “those events that will occur without any action on the part of the holders of the security, but in relation to which the holders have some choice as to the type of benefit they may receive” .

iii. Transaction Management

= **the collective set of** processes available to ensure that any parties involved in a transaction are assured of receiving the correct economic benefits due to them if the transaction is affected by a corporate action.

Transaction management applies both to distribution and reorganization events.

Examples:

- **Market Claims** = processes that redistribute corporate action proceeds where needed, so that the entitled party receives the benefit. This could be necessary due to the transaction itself (e.g. a fail) or positions (e.g. due to a lent position). In all cases the process is related to distribution type corporate actions and looks at who is the actual holder of a security on a record date as well as the entitled holder.
- **Transformations** = processes related to the converting of settlement details of an open transaction as a result of a corporate action on the security. This replaces the need for settling participants to a trade to delete the original settlement transaction and re-input.
- **Buyer Protection** = processes by which the buyer instructs a seller to specify an election or acceptance on his behalf where settlement falls across a record date and therefore the buyer does not have holding of the underlying securities.

iv. General Meetings

There has been a debate on whether General Meetings are corporate actions or whether they represent a category of events on their own. GMs are voluntary.

Processes:

- 1: Notice to convene the general meeting
- 2: Entitlement/shareholder qualification/record date
- 3: Notification of attendance to the general meeting

3. Tenor of the rules regarding corporate actions

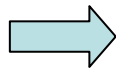
Example:

„The intermediary is obliged to forward to the investor the convocation of a bondholders‘ or shareholders‘ general meeting.“

or

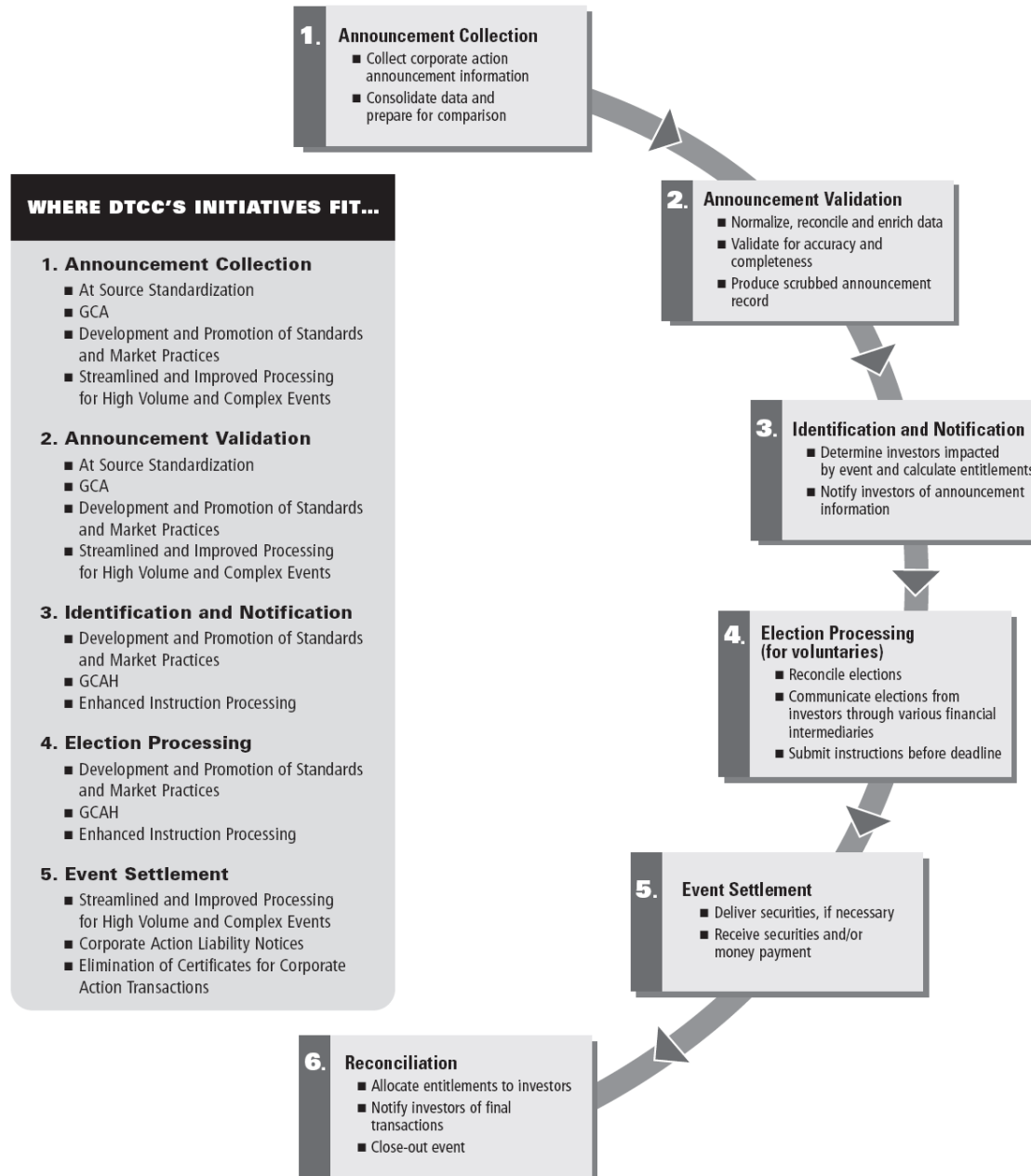
„The investor has the right to receive the convocation of a bondholders‘ or shareholders‘ meeting.“

Which approach is preferable?



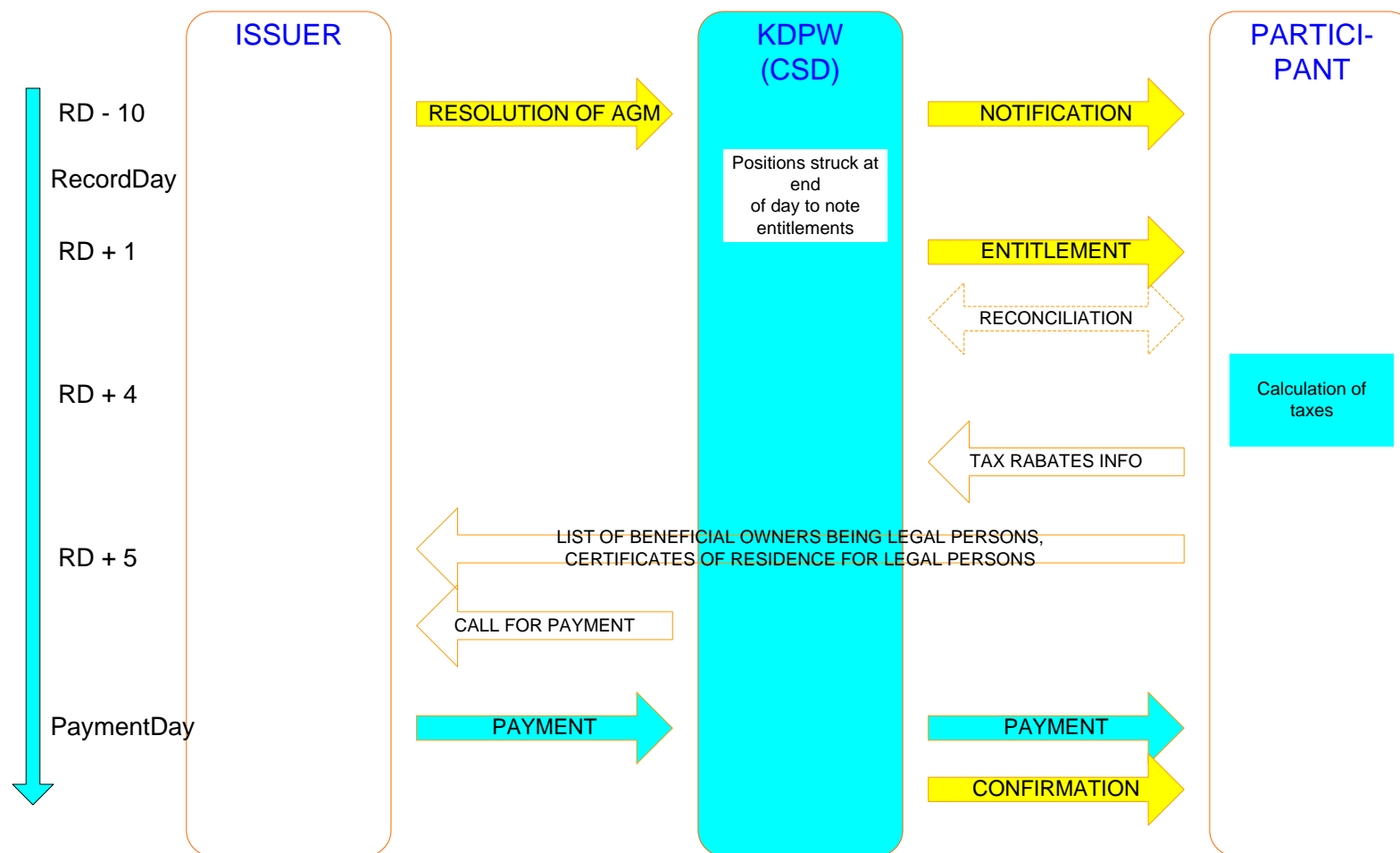
Any other issues to tackle to
complete the scope of the work on
Corporate Actions?

Corporate Action Life Cycle



Source: DTCC White Paper

Life of a corporate action Dividend



Appendix 4

Acquisition of Book-entry Rights

Legal Certainty Group
September 2007

Acquisition of book-entry rights

- The account holder should become entitled to book-entry rights as of the moment at which the credit entry is made on a securities account.
- The credit entry on a securities account should be given priority over other methods to acquire book-entry rights.
- National laws incompatible with those rules should be changed.

Accounts provided by authorised entities?

- The advice stated that the new legislation should cover all account providers, and not those who are licensed.
- Lars A: only authorised entities, difficult to analyze the effects, cumbersome to change laws.
- Joanna B: disagree, no policy justification for denying the account holders legal protection.

Moment of transfer

- First, the rules proposed regarding acquisition of book-entry rights would solve many problems.
- Second, there is no transfer from one person to another in modern SSS and it is therefore illogical to try to find the non-existent moment/transfer.
- No rule should be proposed about the moment of transfer.

Appendix 5

The account holder – account provider relationship

Federico de Tomasi

General issues

- Exclusion of non regulated account providers?
- Effectiveness against third parties.
- Non alteration by contract of book-entry rights subject to minimum harmonisation.
- Professional diligence – no exclusion or limitation of liability of the account provider.

General issues

- Non alteration by contract:
 - clarification of the exact scope of the rights which may not be altered (subject to the outcome of discussion on corporate rights and the duty to maintain sufficient assets);
 - review of the Unidroit Convention (art. 6 and 20).
- Diligence and liability: consideration of the impact of existing EU and national legislation

Issues concerning book entry rights

- Person entitled to give instructions: recognition of exceptions to the exclusive right of disposition of the account holder (Article 18.2 of Unidroit Convention).
- Addressee of instructions; obligation to follow the instructions.
- Right of disposal of limited interests (pledge, usufructus).
- Right of retrieval: is it appropriate that the law of the account provider may restrict it if the law of the issuer does recognize it?

Appendix 6

Legal Certainty Group

Meeting 10/11 September 2007

1.5 PRIORITY

Questions

- **Does the priority rule only apply, as in Unidroit, to the grant of interests in intermediated securities by other methods than book-entry or should a priority rule also be expressed to apply to book-entry credits as such ?**
- **Should a designating entry be fully assimilated to a transfer by book-entry ?**

- **Should a priority be recognized to interests granted to the relevant intermediary ?**
- **Should a priority be granted to control agreements ?**
- **Should a priority be granted to security interests created under national law, but not resulting in a book-entry credit or designating entry ?**

Suggested answer (1)

- **Designating entries fully assimilated to book-entry credits;**
- **Absolute priority to book-entry rights, subject only to**
 - (i) security interests created and perfected in accordance with the FCD, and**
 - (ii) other limited interests created by book-entry and made enforceable in accordance with applicable internal legislation;**

Suggested answer (2)

- **Mere agreements are only granted priority if resulting in a book-entry, a designating entry or if fully enforceable against third parties under national law;**
- **No specific rule for control agreements;**
- **No specific rule for interests in favour of the relevant intermediary;**
- **Exception for priority rules by mandatory operation of law.**

1.6 BONA FIDE ACQUISITION

Question

- An account holder may rely on any book entry made in his name “*unless he knew or ought to have known that the book entry should not have been made*” (2006 Advice) : Should future legislation elaborate on the bona fide test ?

Suggested answer

- EU legislation should leave the application of the test proposed to the national law which will govern that issue under the PRIMA rule as applied in each Member State.

Appendix 7

1.7.1.5. Reasons for invalidity

General principle: Credit is valid and creates rights erga omnes

**Exception 1): Credit made in error by account provider.
Ex tunc invalidity.**

Exception 2): Invalidity (under contract law) of contract that gave rise to the credit. Ex tunc invalidity.

Exception to exception 1)-2): Third party good faith acquisition in credit right prior to "reversal" of credit. Credit becomes valid.

Exception 3): Conditional credits. Ex tunc reversal of credit if the condition is not met.

Exception to exception 3): If the condition was not apparent from the account, reversal cannot be made if a third party has acquired interest in the credit position or account holder has become subject to insolvency proceedings (reversal only with ex nunc effect).

1.7.2. Connection to insolvency law

General principle: Insolvency law is maintained

Exceptions:

-No zero hour-rules applied to credits

-No voidance of credits *merely* based on the credit or interest therein (e.g. pledge) was made in a suspect period.

-No insolvency stay applied to holders of credits including interests therein (e.g. pledge).

- In intermediary insolvency proceedings customers assets are not part of the insolvency estate.

Appendix 8

Attachments

Issue 1: upper tier attachment

Issue 2: attachment of segregated client
accounts

Upper Tier Attachment

- systems where ultimate holder is the owner down the chain but cannot be identified at all layers
- transparent systems
 - ⇒ identification of the decisive record
 - ⇒ information system to be put in place
- definition of attachment

Attachment of Segregated Client Accounts

- MiFID Articles 13.7 and 13.8
- problem: attachment of account provider's assets at a higher tier by one of its creditors
- proposed rule: ensure that accounts of the account provider at a higher tier identified as « client financial instruments account » cannot be attached
- rights of higher tier account provider against « client financial instruments account » to be defined ?