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Legal Certainty Group
Subject 1 ("book-entry securities")
Extract from the draft report: Validity of Credits

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“Validity of credits”

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:

(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. Introduction

In the EU securities markets, sophisticated structures have been developed to allow for the holding and transfer of securities without physical handling. Under such structures, intermediaries are interposed between the issuer of the securities and the investor. These intermediaries maintain securities accounts in which positions in respect of securities are recorded. Commercially and economically, credits and debits to securities accounts ('book-entries') are treated as being equivalent to the physical holding of securities. However, legally the status of these book-entries and their legal effects differ across countries.

It is maintained that as a minimum, clarity about and, to some degree, harmonisation of the effects of book-entries, are prerequisites for tradability, for settlement purposes, and for determining the allocation of shareholders' rights, in particular in a cross-border environment. If the effects differ (e.g. in back-to-back securities transactions or the reliance of a bona fide acquirer) this could potentially affect investors' ownership status, the exercise of certain investor rights, the integrity of the issue and market efficiency.

2. Delimitation of "finality", "validity", "effectiveness", "reversibility", etc.

a) Terminology

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.

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.

Further, 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, (i) 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 (ii) 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.

b) “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.*”¹

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 rise to concerns about the position of a third party relying on the credit).

c) Validity of book-entries and its effects

The 2006 Advice (point 5.7) 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.

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

¹ Second Report on EU cross-border clearing and settlement arrangements, p. 15.

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 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.

Further, 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 to credits.

Consequently, the 2007 Advice should state 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 transferor’s right to re-claim securities under contractual or non-contractual rules of law.**
- **Finality of settlement would occur upon validity of a book-entry or upon good-faith acquisition. It is still to be further discussed whether there is a need for uniform rules on the time after which reversal will be excluded. It needs to be analysed further whether protection against systemic risk requires stricter rules on finality of settlement with designated securities settlement systems.**

d) 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: Debit 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 one of the two following principles applies:

(1) 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.

(2) National law requires a valid contractual obligation as a precondition for a valid book-entry, provided that such condition and its fulfilment is made sufficiently transparent (see also example 3 below).

In any of those two options, third parties acting in good faith should be able to rely on a credit.

- Example 2: Contract gave rise to a credit, but the contract was invalid under contract law and the applicable law does not require a valid contract for a valid book-entry.

In such case, validity of the credit should not be dependent on defects of the underlying obligation.

An intermediary would 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 would 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. It is acknowledged, however, that if the transferee becomes subject to insolvency proceedings, the transferor may not be able to enforce a re-transfer unless national insolvency law provides for a priority entitlement of the transferor.

- Conditions

If national law maintains 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.

The validity of the book-entry is conditional/contingent upon the fulfilment of the conditions. A key element will be transparency of the conditionality of the book-entry and its fulfilment (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 of the book-entry and its fulfilment (see below).

- Example 5: A credit was made by intermediary, with the credit being subject to the fulfilment of a payment obligation of the intermediary and 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 of the book-entry and its fulfilment (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.

It is noted that the option (ii) would not necessitate the same degree of transparency as option (i), however, existing practices such as contractual settlement might no longer be possible.

- Example 6: A credit of securities is linked by way of a DvP arrangement to a corresponding cash payment and the jurisdiction concerned allows for credits to be made before the reciprocal fulfilment of the payment obligation.

DvP arrangements differ from jurisdiction to jurisdiction. Therefore, different alternatives to permit DvP could be envisaged. If credits in respect of the securities leg can be made without at least simultaneous settlement of the cash leg, a key element will be transparency of the conditionality of the book-entry and its fulfilment (see below).

e) Reversals/Voidance

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

It is felt appropriate that the 2007 Advice should permit a right of reversal in case of invalid book-entries, lack of authorisation or erroneous booking, 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: Debit did occur without authorisation of the entitled person.

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 by the intermediary, subject to the protection of third parties, having acquired in good-faith.

- Example 8: 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.

g) 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 is felt appropriate that the 2007 Advice should give preference to an ex tunc effect (see the principles below).

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 of the account holder.

- **To maintain the integrity of the intermediated holding structure, as a general rule an intermediary should only be obliged to reverse a book entry upon instruction by either the account holder or a court.**
- **If the book-entry to the account was invalid, made in error or without authorisation 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 credit was made conditional (e.g. of payment to the intermediary), or the contract that gave rise to the book-entry was invalid under the law governing the contract and validity of the contract is a precondition of a valid book-entry in such jurisdiction and the condition cannot or may no longer be met, the intermediary may re-debit the account – with ex tunc effect - unless a third party acting in good faith has acquired an interest in the credit position.**

h) Transparency of conditional/blocked book-entries

As elaborated above, there are several fact patterns where a credit may be conditional. Examples comprise:

- A credit is conditional of a payment.
- A credit is conditional of an upper-tier credit.
- A credit is, according to national law, dependent on the validity of an underlying contractual obligation.
- An account (or specific entries on an account, depending on the jurisdiction) is attached (e.g. as a consequence of a court order).

There is a need to determine if such conditions need to be made transparent from the account or at the least limited in time. In point 5.8 of the 2006 Advice, it is stated: *“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.”*. This advice may need to be further expanded in the 2007 Advice.

First of all, as stated above, it should be made clear that a condition (of whatever kind) cannot be invoked against a person that acquired an interest in the credit position in good faith, if the condition was **not** apparent from the account (transparent).

If the condition is apparent from the account, the condition should be upheld against the acquirer or any other third party (who should have checked the account and thus should have discovered the conditionality).

However, it may be discussed whether there is need to establish rules that require that a condition should be transparent from the account **and that it should also be easily ascertainable what the nature of the condition is and when it is usually fulfilled.**

Secondly, in cases where a condition is not transparent from the account, it has to be discussed whether the 2007 Advice should suggest limitations of the right to invoke a condition against persons others than good faith acquirers, e.g. creditors of the account holder (including an insolvency administrator). This would be relevant e.g. for legal systems, which do generally impose conditions on book-entries (such as value dates of T+x), without making those conditions transparent from the book-entry itself.

This non-transparent conditions in itself may not be an issue as long as the effects are confined within one system or intermediary, for instance by blocking such entries until the condition is fulfilled. In this regard, limitations to the right to invoke such non-transparent conditions might ensure adequate information and protection of the account holder itself, but also of third parties relying on the status of the account holder's positions/holdings (subject, however, that the conditionality was not apparent from the general legal and/or operation framework applicable to a system or intermediary).

However, if such non-transparent conditional bookings could be transferred/passed down a chain of intermediated holdings into another jurisdiction, this might contaminate the integrity of the issue and/or create a domino effect if the condition is not materialising.

In this respect, a possible compromise could be to allow non-transparent conditions to be invoked against persons (other than good faith-acquirers), however, subject to a blocking of entries made under a non-transparent condition, and complemented possibly by a time limitation, e.g. providing that that non-transparent conditions actually cease to exist (at the latest) a specific number of days after the credit was made.

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 a solution that ensures that conditions are either made transparent from the account or limited to the intermediary/system in question and/or in time.

3. 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.

- Example 9: 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 10: 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 11: 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*

voidance of transactions entered into during the prescribed period referred to in paragraph 1(b) and in paragraph 3(i)."

- Example 12: 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 voidance of transactions other than for the mere fact that they have been made during a suspect period should be maintained.

4. 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.

5. 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.