

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

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Terminology

- 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

“Credits constituting evidence”

- 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)

Validity of book-entries and its effects

- 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.

Reasons for invalidity

“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
- Underlying obligation
- Conditions
- DvP

Lack of instruction/authorisation

- 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 2008 Advice should also reflect this principle.

Underlying obligation

- Further, the 2008 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.

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.

- 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.

Reversals/Voidance

- It is felt appropriate that the 2008 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.

Effect of invalidity, reversal and voidance

- It is felt appropriate that the 2008 Advice should give preference to an *ex tunc* effect
- A book-entry is considered valid and providing 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

Effect of invalidity, reversal and avoidance

- 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.

Transparency of conditional/blocked book-entries

- 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.**

Transparency of conditional/blocked book-entries

- Secondly, in cases where a condition is not transparent from the account, it has to be discussed whether the 2008 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.

Transparency of conditional/blocked book-entries

- 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.

Connection to insolvency law

- **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 2008 Advice.** In case of an intermediary insolvency, the customers' assets (including those held at an upper-tier) are not part of the insolvency estate.