“Regulatory Regime at EU Level”

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EU Legal Certainty Research Sub-Group

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This note aims to provide an overview of the way in which the provision of securities accounts in the European Union is currently regulated.
In this exercise the word "regulatory" is to be understood as "rules that alter or moderate the behaviour of the regulated entity". Thus, the regulatory regime may be contrasted with the substantive legal regime.

1. The regulatory provisions

a) *Directive on Markets in Financial Instruments* (“*MIFID*”)[1]

The MIFID Directive requires the Member States to harmonise the rules governing investment services and the pursuit of investment activities. To that end, the Member States must set up a "single passport" system enabling investment firms to operate throughout the EU. The authorisation from the home Member State may also cover ancillary services, such as “*safekeeping and administration of financial instruments for the account of clients* […]”, Art. 6 (1) MIFID.

With respect to safeguarding client’s assets, Art. 13 (7) MIFID states that an “investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard client’s ownership rights […].” Under Art. 13 (8) MIFID an “investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights […].”

The Level 2 Advice of CESR suggests the necessary arrangements to be taken by investment firms (and by credit institutions when placing such assets with third parties). Investment firms (while not being licensed as a credit institution) “*must deposit*” client financial instruments with designated institutions, e.g. credit institutions or central banks.[2] Moreover, investment firms “*may sub-deposit*” client financial instruments to a depository and, where such depository is “*subject to specific regulation and supervision*” under the relevant jurisdiction, the investment firm “*must deposit*” the financial instruments of the client to such a depository.[3] When placing the instruments with a depository, the investment firm has to ensure that client financial instruments are separately identifiable from its and the depository’s proprietary financial instruments by virtue of distinctly titled accounts on the books of the depository and by the way the instruments are held by the depository.

With respect to access to CCPs and clearing and settlement facilities, Art. 34 (1) MIFID requires Member States to ensure that investment firms from other Member States have non-discriminatory access to “*central counterparty, clearing and settlement systems in their territory for the purposes of finalizing or arranging the finalization of transactions in financial instruments*.” Further, Art. 34 (2) MIFID provides that, subject to certain qualifications, Member States shall require regulated markets in their territory to offer all their members or participants “*the right to designate the system for the settlement of transactions in financial instruments undertaken on that regulated market*.”

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[1] DIRECTIVE 2004/39/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 April 2004 on markets in financial instruments, OJ L 145/1, 30.04.2004, p 1
[2] CESR’s Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates, January 2005, No. 9, p 36.
[3] CESR’s Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates, January 2005, No.10, p 37

b) Directive relating to the taking up and pursuit of the business of credit institutions ("*BCD*")[4]

The BCD constitutes the essential instrument for achieving the single market in the field of credit institutions, making possible the granting of a single licence and application of the principle of home Member State prudential supervision. The Directive provides, *inter alia*, for a common capital requirement regime for credit institutions covering own funds, risk weighting of asset items and solvency ratio level as agreed by Basel Committee of Banking Supervision.

Art. 1 (5) BCD defines a "*financial institution*" as being an institution other than a credit institution which engages in the activities listed in No. 2-12 of Annex I, e.g. "*safekeeping and administration of securities*".[5] Art. 19 BCD requires Member States to provide "*that the activities of Annex I may be carried on within their territory, in exercise of the voting rights attaching to the shares held by the shareholders or members in question*".

c) Directive on capital adequacy of investment firms and credit institutions ("*CAD*")[6]

The CAD lays down a standardised method for the calculation of capital requirements for market risk incurred by investment firms and credit institutions, in particular position, settlement / delivery and foreign exchange risks.[7] The CAD Directive has been subsequently amended to introduce the new market risk provisions allowing institutions to use "*internal models*" for the due assessment of market risks (CAD 2).[8]

d) Settlement Finality Directive ("*SFD*")[9]

Pursuant to Art. 2 a) SFD, a Member State has to designate and notify a system within the meaning of the SFD to the Commission when such Member State is satisfied as to the adequacy of the rules of the system.

e) Money Laundering Directive ("*MLD*")[10]

Art. 3 MLD requests Member States to ensure that credit institutions and financial institutions shall require identification of their customers when opening an account or when offering safe custody facilities.

2. Current Regulatory Developments

a) Basel II / CAD 3[11]

The European Commission has presented a proposal for new capital requirements for credit

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[4] DIRECTIVE 2000/12/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L 126/1, 26.05.2000, p 37

[5] No. 12 of Annex I of BCD Directive

[6] Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions OJ L 141, 11.06.1993, p 1

[7] Annex II of Council Directive 93/6/EEC;

[8] Directive 98/31/EC of the European Parliament and of the Council of 22 June 1998, OJ L 204, 21.7.1998, p 1;

[9] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, Official Journal L 166 , 11.06.1998, p 0045 – 0050

[10] Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering, OJ L 166, p 0077- 0082

[11] Proposal of the European Commission for DIRECTIVES OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL - Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (COM (2004) 486 final))

institutions and investment firms to ensure the application throughout the EU of the new capital framework recently agreed by the Basel Committee on Banking Supervision. The proposal will replace the BCD as well as the CAD Directives, allowing credit institutions and investment firms to apply internal risk assessment standards for the assessment of credit, market and operational risks.

b) ESCB - CESR Standards[12]

In September 2004, the European Central Bank and CESR jointly adopted standards for clearing and settlement to promote *the safety and efficiency of clearing and settlement activities in the EU* (the "Standards"). The Standards are mainly applicable to CSDs, ICSDs, CCPs and "*custodians that manage significant arrangements for settling securities transactions*". The Standards are to be conformed to on a "*best endeavour basis*", i.e. they do not have legal status. ECB and CESR currently review the Standards.

Standard No. 12 is addressed to entities providing securities accounts and requires them to segregate in its books customers' and proprietary securities in order to cover the risk of claims of creditors of the account providers (not the creditors of the account holder). Art. 12 therefore reads that it is essential that customer's securities shall "*be protected against the claims of the creditors of all entities involved in the custody chain*". Securities clearing and settlement systems, whilst maintaining safe and secure operations, should be "*efficient*", Standard No. 15.

c) Cross border shareholder voting rights / proxy voting[13]

In September 2004, the European Commission has launched a public consultation on facilitating the exercise of basic shareholders' rights in company general meetings and solving problems in the cross-border exercise of such rights, particularly voting rights.[14] In such consultative document, the European Commission expressed, in the absence of a rule at EU level, the need to create legal certainty "*over who controls the voting right to the exclusion of anyone else*" as cross border shareholding with in the EU involves chains of securities intermediaries.[15] The majority of the respondents to the consultation was of the opinion that the entitlement to control the voting right should rest with the person having the genuine economic interest in the shares (the ultimate investor).[16] Moreover, a majority of respondents considered that Member States should allow the ultimate investors to exercise voting rights by offering a variety of possibilities to do so, e.g. registration or acknowledgement as a shareholder, the account provider formally entitled to vote granting a power of attorney to the ultimate investor or that ultimate investor giving voting instructions to such account provider.[17]

[12] ECB / CESR, Standards for securities Clearing and Settlement in the European Union, September 2004 Report, p 2

[13] A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE (A CONSULTATIVE DOCUMENT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, Section 3.2.)

[14] Fostering an Appropriate Regime for Shareholder's Rights, Consultation document of the Services of the Internal Market DG, see http://europa.eu.int/comm/internal_market//company/docs/shareholders/consultation_en.pdf

[15] Fostering an Appropriate Regime for Shareholder's Rights, Consultation document of the Services of the Internal Market DG, p 9

[16] Synthesis of the comments on the consultation document of the services of the internal market directorate-general "Fostering an appropriate regime for shareholders' rights", see http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation-synthesis_en.pdf

[17] *ibid.*