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Title Review of Recognition of Indirect and Direct holdings		

Review of the Memorandum regarding the Recognition of Status of Derivative Holdings

To: EU Legal Certainty ‘core issues’ sub group

I have volunteered for the task to comment and review the core issue ‘Recognition of [Direct and] Indirect Holdings’. Dario Loiacono has produced a report to the sub group on this issue (‘Recognition of Status of Derivative Holdings’, the ‘Report’).

I find the Report most illuminating and I can agree to many of the suggestions made in it. In my capacity as the reviewer, I would like to make the following remarks to the question at hand:

Scorned but practicable dichotomy

1. Direct holding systems have been described as traditional systems in which the owners of securities have a direct relationship with the issuer. The investors are either recorded on the issuer’s register or they are in physical possession of bearer securities certificates.¹ The concept of ‘direct holding’ is also frequently used to describe the Nordic systems in which securities accounts of individual investors are maintained by the CSD while the investors’ access is arranged through intermediaries operating the accounts. This structure facilitates registration of the investor automatically in the issuer’s register. The concept of direct holding operates also as the opposite pole to concept of the indirect holding system which assumes one or more tears of intermediaries between the issuer and the investor and which tends to operate on the basis of omnibus accounts. The analysis of the responses provided by Legal Certainty group members provides that neither of the models is thoroughbred.
2. In the Report the differentiation between direct and indirect systems has been pushed into the background. The Report introduces a new concept, *derivative holdings*, to describe both holdings held by the investor with an intermediary or with a CSD through an intermediary. Thus, the concept of derivative holdings encompasses both direct and indirect systems.
3. One can easily agree that the concepts of direct and indirect holdings have significant shortcomings, as the solutions adopted in different jurisdictions vary. All book-entry securities systems are *de facto* intermediated, and in this sense *de facto* indirectly held². In the Unidroit –process, the concept of indirect holdings has been abandoned and currently the proposal deals with ‘intermediated securities’ referring both to securities (accounts) held with an intermediary and to accounts held in a CSD. Article 1(4) of the

¹ See the Bernasconi Report 2000 on the Hague Convention.

² Francisco Garcimartín Alférez: Direct and Indirect Holding: The Challenge for the Functional Approach, Seminar paper, Bern 15 – 17 September, 2005

Hague convention assimilates the CSD with an intermediary. Nevertheless, the concepts of direct and indirect holdings are used frequently for practical purposes and for lack of better formulations. I use this dichotomy in this review while recognising its shortcomings.

Recognition of direct holding systems

4. The Legal Certainty group has intended to include recognition of direct holding systems in the analysis of the sub group. In Unidroit, reference is made to ‘transparent systems’ meaning roughly the same as direct holding systems.
5. It is generally assumed that the Nordic systems (including the Swedish, Finnish, Danish, Norwegian and Icelandic systems) represent the direct holding pattern. To label the Nordic markets as purely direct systems is to some extent an illusion, since all the Nordic systems provide also the choice to hold securities in an omnibus account and in an indirect holding pattern. The freedom of choice is utilised extensively in the cross-border context.
6. The disadvantages of indirect holding systems with omnibus accounts can be translated into advantages of direct accounts/direct holdings. In a direct holding system there is less (or no) risk of shortfalls, there is less (or no) risk for forced borrowings, the issuer and the investor have a direct contact (there is no distance), corporate actions and dividends can be processed efficiently all the way to the investor level without remodification which is necessary when the holding is intermediated, there is no problem of conflicting votes, and there is more legal certainty in respect of securing the title to the securities.
7. The advantages of direct holding systems have immediate implications on efficiency and safety. Consequently, there are a number of EU jurisdictions that do allow and promote direct holding. Having taken an alternative approach to the responses provided in respect each of the jurisdictions, a significant number of the current EU Member States might be described as having adopted an owner-oriented, transparent or direct approach to holdings in their securities law. These jurisdictions include Denmark, Estonia, Greece, Cyprus, Malta, Portugal [?], Slovenia, Slovakia, Finland, Sweden and, to a certain extent, the UK. In the European Economic Area, also Norway and Iceland should be counted in this group.
8. Outside the EU, the emerging markets seem to be adopting the direct holding pattern. For example China and India have established a direct system as a basis for the holding structure in their respective markets. As a banal example: the number of accounts in the CSD in India has just exceeded the level of 10 million and it keeps growing. The Chinese CSD maintains 72 million accounts. This development is mainly attributable to the technological evolution which has permitted the emerging markets to step over certain stages of the development that have been necessary in the more mature markets. One might venture to suggest that if the mature markets were able to start from scratch now, they might not end up with an indirect holding system.

9. It is hardly conceivable that the EU would make an evaluation of the different existing solutions and decide to promote only one. Direct holding systems should not expect the indirect markets to change their basic paradigm into the direct approach. Similarly, given the advantages and the public policy considerations relating to the direct systems, it might be rather difficult to convince the direct jurisdictions to replace their systems with something they could consider as a step back in the development.
10. This being said, it is certainly necessary that the indirect holding pattern is recognised throughout the EU. With the words of the Commission: “Cross-border Clearing and Settlement in the EU is generally less efficient, more expensive, and potentially less safe than the purely domestic one.” Since cross-border investments are channelled with an overwhelming majority through chains of intermediaries and indirect holdings, the proposals to remove this market failure should logically address the indirect holding pattern. Where the existing market practice of chained indirect holdings is not recognised, the lack of recognition creates a legal risk.
11. However, also the recognition of the direct holding pattern is called for in order to secure the safety of an investment made directly on cross-border basis. I believe it is not enough to state that nothing is to be done for any domestic law applying to domestic holdings (ref. summary of the 2nd meeting of the subgroup). I would agree with the Report on the point that to avoid legal uncertainty, the creation of a securities entitlement in one Member State should not be challenged by another Member State. This should apply irrespective of whether the holding is direct or indirect.

Securities holding system is a compromise

12. Securities holding system is always a compromise between different interests and technological possibilities. There is a delicate balancing act to be done on how much of the needs of issuers and investors are taken into account in the design or whether the design reflects primarily the interests of the intermediaries representing the market. Another policy decision has to be made in respect of the conflicting interests: the protection of ownership on one hand and the efficiency of the markets on the other hand. Max Ganado has provided a good description on this balance in his report (Preliminary Report on the Legal Effects of Book-Entry) differentiating between Owner-driven and Intermediary-driven systems.
13. It shall be noted that even the new Swiss law (Federal Act on the Custody and Transfer of Securities Held with an Intermediary) is based upon a compromise which recognises the existing structure of the market and the IT investments made by the participants.³

³ The memo which has been kindly provided to the Legal Certainty Group by the Swiss National Bank states that the working group outlining the legal framework for the securities law reform “decided to follow established market practices unless there was a clear need to depart. Since the holding of securities with intermediaries relies on sophisticated IT-systems, any change in market practice could cause expensive changes in those It-systems.”

There is no empty blackboard for the regulator to fill. The market realities seem to play an important role in designing the legal framework.

Compromise with respect to the Legal Certainty Project

14. An interesting discussion has emerged about the nature of the rights arising from a book-entry in a securities account among the sub group. While there is generally speaking a consensus that something is needed for all Member States laws applying to cross-border holdings, the opinions differ on whether such harmonisation should create a new class of assets (such as the ESI) or whether the object for the rights should be the underlying securities.
15. I tend to agree with the analysis in the Report that the existing fragmentation with respect to the legal characterisation of the nature of the rights does not create a legal barrier as such since the existing domestic systems are considered efficient and safe. The problem seems to relate to the interconnectivity of these different systems and the lacking mutual recognition of the legal characterisations. After reading responses to question nr. 40, it seems that majority of the Member States lack clear rules applicable to the rights of domestic investors to foreign securities credited to a domestic account.
16. The current domestic holding systems have their underpinnings partly in the corporate law environment and governance culture typical for each Member State. Also for this reason imposing a single and exclusive solution on all Member States would not seem to be the right approach. Hence, on my part the loose consensus to leave the domestic law applying to domestic holdings intact and address primarily the cross-border holdings seems a sound way forward.
17. This approach would suggest that Member States should ensure that if the law of that Member State is applied, the cross-border holdings shall be covered by legislation guaranteeing a minimum level of protection. The minimum level should be set in an EU level instrument providing qualitative criteria for the framework of cross-border holdings. The approach could be generally the same as adopted in the Unidroit process.
18. Nevertheless, there may be areas or gaps in the law on domestic holdings that the Member States may wish to bridge with a common EU wide framework. The EU solution should present a minimum level of harmonisation that could be extended by a Member State to apply also to other than purely cross-border situations.

Other comments on the Report

19. I am not totally convinced of the reference (under the heading The Concept of Securities Entitlement) in the Report to the majority opinion among scholars that the securities entitlement is a derivative legal asset distinct of the underlying securities. While recognising the significant authority of Joanna Benjamin and Roy Goode in this field, I believe most of the legal literature written on the subject of securities holdings is domestic and published in the domestic languages which probably has not been analysed.

20. In the last paragraph of the Report, a reference is made to the difficulties which arise in certifying an investor's right to participate in a shareholders meeting. I don't think it is necessary to include it in our analysis, since this is an issue that is discussed thoroughly in the context of the proposal for the Shareholders' Rights Directive.
21. On page 3, in the last paragraph before the chapter on Results of the Survey the Report suggests that the barrier for mergers between CSDs relates to the different solutions of the legal framework in Member States. Furthermore, it is suggested that these differences prevent the abolishment of vertical integration between different operators. I'm afraid I have to disagree with this notion since I don't think it is substantiated by evidence, nor is it within the scope of the work of the Legal Certainty Group. Firstly, combinations of central securities depositories, exchanges, banks and other operators into common cross-border group structures have occurred without unified substantive rules. Secondly, I don't see how the structural issues could belong to the mandate of the Legal Certainty Group. Lastly, the suggestion seems to be in contradiction with the reference made later on page 4 calling for competition between the operators through introduction of a single asset.

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21 March, 2006