

LEGAL CERTAINTY GROUP

Moment of Transfer

This analysis primarily refers to Question 19 of the Questionnaire

‘At exactly what moment or moments in time does a transferee become entitled, and to what?’

At what moment or moments in time does the transferee become disinterested?’

Nevertheless, our analysis can not come to final conclusions by only reviewing the answers to Q 19, but has to consider also answers to other questions e.g. Q 3, 7, 8, 11, 12 and 17.

The part ‘to what’ a transferee becomes entitled has primarily to be dealt with under the topic “Legal Effects of Book Entry”. Of course, differences in the substrate of a holding may cause distortions to the interoperability especially in longer chains of (cross border) holdings. Such distortions, however, will hardly result from differences in timing.

Obviously, legislation is generally limiting itself to stating that the mechanism for transferring book-entry securities is through account entries. It might refer to the debiting or crediting (or both simultaneously) as the moment when a book-entry security is transferred, but does generally not go to the level of the how this is implemented operationally.

It must be recognised, based on the answers to the Legal Certainty questionnaire, that legislation and (self-)regulation in Member States generally is more specific in relation to the moment of transfer when these take place in the local CSD as opposed to taking place in the books of any other intermediary.

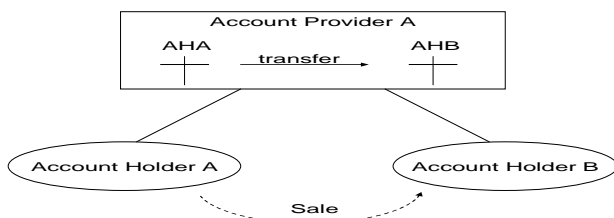
We have therefore analysed the responses to the questionnaire on the basis of the following two scenarios:

Scenario I. ONLY ONE ACCOUNT PROVIDER INVOLVED

Account Holder A (AHA) sells securities to Account Holder B (AHB). AHA and AHB both have a securities account with Account Provider A (APA).

For the purposes of the current legislative framework and this analysis, we can distinguish between the following two cases:

- a) APA is the local CSD; AHA and AHB are participants (and final investors) of the CSD.*
- b) APA is an account provider other than the local CSD; AHA and AHB are customers of APA and final investors.*



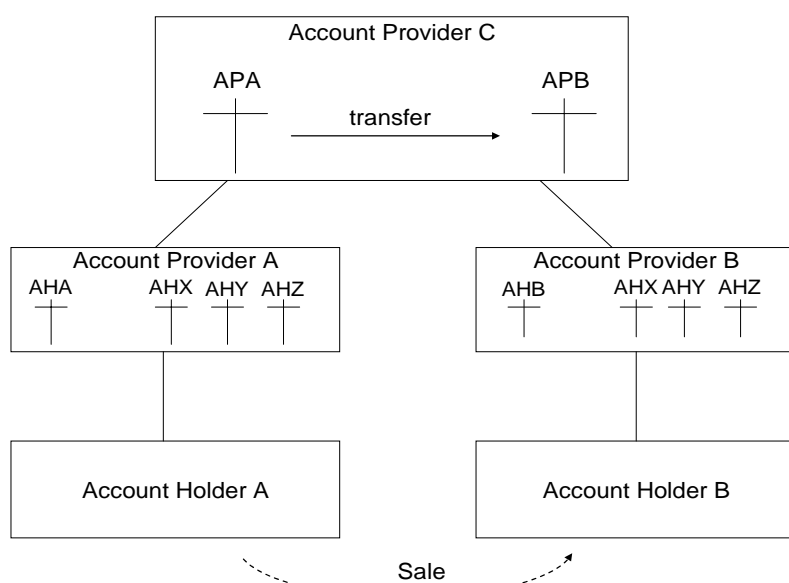
Scenario II. SEVERAL ACCOUNT PROVIDERS INVOLVED

AHA sells securities to AHB. AHA and AHB are final investors and do not maintain securities accounts with the same intermediary.

Account Providers A and B act in the dual role of account provider and account holder.

Account Provider C is typically a CSD.

For better understanding we assume that AHA placed a sale order with APA whereas AHB placed a purchase order with AHB; both orders have been executed and are settled through APC as CSD.



Scenario I will mostly be a domestic scenario where the two account holders typically have entered into a sales contract which is settled by instructing APA to debit and credit the respective securities account. Of course, AHA and/or AHB may also be residents of a country different from APA's home country. Scenario I is generally not capital market related but rather represents a private direct transaction between AHA and AHB. General principles of civil law governing the transfer of tangibles and intangibles will apply.

Under operational aspects it is up to AHA and AHB to take the steps necessary to effect the transfer of the securities which will include that AHA instructs APA to debit his securities account and to credit AHB's securities account accordingly. Such credit entry may, but need not necessarily, represent the final step to effect the transfer and, consequently, would be the moment in time when AHB becomes entitled to the securities.

Scenario I may have market relevance, however, where APA is internalising sale and purchase orders of its customers. In such cases APA would most probably first acquire (co-)ownership of the securities from AHA and then transfer it to AHB. Whether the transfer becomes effective upon crediting AHB's securities account or at an earlier moment in time based on a civil law effect depends upon the legal regime applicable to such transaction.

Obviously, countries have concentrated on Scenario II when modernizing their legislation on trading and transferring securities in book entry form and left such

private transactions unchanged. Some countries obviously do not have legislation at all providing for the transfer of securities in book entry form where the credit on a securities account completes the transfer of the securities, e.g. Cyprus and eventually Malta.

Scenario II may be either domestic (if all account providers involved are located in the same country) or cross border, if at least two of the account providers are located in different jurisdictions. It seems most useful, however, to concentrate on a domestic scenario II and on the a.m. sale /purchase transaction executed on the relevant securities market and settled via book entries. Since it is AHB who buys and pays ultimately for the securities we have to look at two levels where book entries are made: (i) APC (= CSD) credits and debits the securities accounts of APB and APA respectively and (ii) APB credits the securities account of AHB whereas ABA debits the securities account of AHA.

The result could then be tested against the answers in Section IV of the questionnaire to establish whether the outcome would be different if the upper tier account provider is located in another country or whether legislation differentiates on the basis of the nationality of the securities being transferred (for example, domestic legislation providing a specific framework for dematerialised securities) or of the location of the securities (*lex rei sitae*).

1. Analysis of differences – Scenario II

1.1 Credit entry

As a general rule, making the credit entry on the securities account of the transferee can be regarded as the moment when (co-)ownership or other entitlement to the securities passes to the transferee provided, of course, that there are (i) a valid instruction from the transferor and (ii) sufficient securities in his securities account to be transferred. Should there be any deficiency in this respect, the result is most probably different and involves questions of shortfall and bona fide acquisitions principles; such deficiencies, however, are regarded as irrelevant in the context of this analysis and are not reviewed any further. The same approach is taken with respect to the fulfilment of certain additional requirements e.g. registration in the shareholders register in order to be entitled to exercise certain corporate rights (see

e.g. Italy Q 17). Such additional requirements have to be analyzed in the context of prerequisites for exercising corporate rights but not here, unless e.g. the registration is a mandatory element to become entitled to the securities purchased which does not seem to be the case.

The credit (and debit) entry on a securities account can be regarded as a technical process starting with the account holder giving, or causing to be given, the instruction which is then checked as to authorization and sufficient number of securities to be credited followed by the technical process of the entry which thereafter has to be checked as to correctness and which is communicated to the transferee. Legislation does not seem to be specific on the exact moment in this sequence of technical steps, i.e. when the credit entry shall become effective. This is understandable in light of the comparable situation of crediting a money account which involves similar steps. It is our understanding that any error may be corrected by cancelling the credit entry before such credit entry becomes legally effective provided that the error has been detected in the course of checking the entry process. Consequently, the technical step of making the credit entry which is part of the electronic system is not yet the exact moment when it produces its legal effect of transferring co-ownership or other securities entitlement. It depends upon **when** the account provider considers the process of making the entry as completed which is the case at the latest when an account statement is despatched or when the account holder sees the credit entry on his screen.

To give an example: Clearstream Banking Frankfurt (CBF) as the German CSD provides in its General Business Conditions (No.8 (1)) that joint possession of securities held in collective safe custody, i.e. in book entry form, shall be deemed transferred to the transferee 'upon completion of the accounting entry'. But when is the accounting process completed? For this purpose CBF has implemented a 'system stamp' which marks on the books of CBF exactly the moment in time when CBF considers this process as completed. Such procedure enables CBF also to fully comply with the principle 'Delivery v. Payment'.

Some of the answers to Q 19 or 17 refer to the two (or more) levels mentioned above on which credit entries on securities accounts may occur:

- (1) the CSD - Account Provider (= Account Holder, but not final investor) level
and

(2) the Account Provider – Account Holder (= final investor) level, and discuss which credit entry is the legally relevant one for the entitlement of the final investor.

As a rule it can be said that the credit entry on level (1) does not confer the right/entitlement to the final investor before the credit entry on level (2) has been made. Should this level (2) credit entry be made prior to or simultaneously with the level (1) credit entry, (co-)ownership may be acquired by the final investor at the moment when the level (1) credit entry becomes effective, i.e. both credit entries become effective at the same moment in time. This effect can be achieved by making the level (2) credit entry under the condition that level (1) credit entry is made on the settlement date and becomes effective only at that moment.

Of course, if the CSD makes credit entries on securities accounts carried for ultimate investors which seems to be the case under the Nordic system and in Spain, such credit entry transfers rights directly to the final investor.

In jurisdictions which provide for absolute (co-)ownership rights being acquired through crediting the securities account it has to be distinguished between a direct transfer of (co-)ownership from the seller to the final purchaser without the account provider acquiring any interim (co-)ownership (e.g. Germany) and a transfer system whereby the account provider becomes temporarily the (co-)owner of the securities. Where the interim co-ownership scheme applies the moment in time when the final investor acquires co-ownership or other entitlement is normally the moment when the account provider credits the securities account of his customer and not already when the CSC credits the account of such account provider. In jurisdictions providing for sui generis solutions to the effect that a securities entitlement vis-à-vis the next higher intermediary is subject to the credit entry, the account holder on each level will become entitled when his securities account is credited.

We have detected a difference with respect to the source of the effectiveness of a credit entry, i.e. whether it is really the technical procedure of such operation having the legal result of transferring rights to the transferee or whether the credit entry merely evidences such transfer which is the result of express and/or implied legal acts/declaration of the parties involved (see Q 17 Germany). Whether such difference in systems matters will be discussed below.

1.2 Debit entry

Entitlement through credit entry and disentanglement through debit entry coincide in many jurisdictions, i.e. no credit without debit. Again, it has to be distinguished between the two (or more) levels on which debit entries are made. Normally, the debit entry on each level mirrors the effect of the corresponding credit entry. Legislation often seems to be silent on the legal effect of debit entries. It is, however, a logical consequence that the transferor loses his co-ownership rights at the very moment when the transferee acquires such rights irrespective of whether or not the transferor's securities account has already been debited. On the other hand, it is a fundamental accounting principle to always make a corresponding debit entry when crediting an account.

Problems may arise when there is a discrepancy between the two entries which may be timewise or in substance with respect to the number or amount of securities.

1.3 Delivery vs. Payment

The elimination or reduction of counterparty and market risk is of utmost interest to market participants. Consequently, many settlement systems are based on the principle of delivery versus payment. This can be achieved by either making the credit and debit entries on the securities account not earlier than the cash settlement or by making the credit and debit entry conditionally upon completion of the cash settlement or by deliberately postponing the legal effect of the credit entry as described above for CBF (system stamp). Such techniques have an impact on the moment in time when a credit (and debit) entry becomes effective, but are necessary to achieve dvp.

1.3 Summary of differences

We have detected the following differences in member state jurisdictions:

- (i) Credit/debit entry constituting the legal effect of transferring co-ownership or other entitlement vs. only evidencing the transfer which is constituted by other action;
- (ii) Entitlement of transferee and disentanglement of transferor always coincide or not;

- (iii) Ultimate investor acquires co-ownership or other entitlement at the moment in time when the upper intermediary (normally the CSD) credits the securities account of his participant or only thereafter when the participant makes the credit entry on the investors' securities account;
- (iv) The CSD's participant acquires interim co-ownership in the settlement process or not.
- (v) Some regulations define the exact moment when the credit entry has to be regarded as completed and having legal effect, most do not.

2. Solutions

Under the aspect 'moment of transfer' none of the a.m. differences requires EU legislation. The analysis makes evident that it is the moment of the credit entry on the securities account when the transfer becomes effective. The fact that the occurrence of the effectiveness does not necessarily coincide with the termination of the technical process of the credit entry but either expressly or implicitly allows certain control steps thereafter or even the satisfaction of certain conditions (e.g. cash settlement) does not require detailed legislation. History has shown that flexibility is of essence in the field of clearing and settlement of securities transactions. The same positive experience has been made in respect of credit and debit entries on money accounts.

The answer may be different under the aspect of the soundness of a clearing and settlement system whether the effectiveness of credit and corresponding debit entries may occur at different moments in time and whether the entire settlement process should provide for a direct acquisition of rights/entitlements by the account holder as ultimate investor from the seller or whether interim co-ownership of the account provider may be tolerated. This question does not have to be answered primarily under the issue 'moment in time'.

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