

Preliminary Report for the EU Clearing and Settlement - Legal Certainty Group

Dated 26<sup>th</sup> February 2006

**Re : Legal Effects of Book Entry**

**This Report is divided into parts for convenience and each part will be reviewed as required and the discussion progresses.**

**Sources and Process**

**Sources –**

In preparing this report the following sources were used and processes followed :

**1. Legal Certainty Group Questionnaire**

All the replies from each of the EU states to the Questions 7 and 12 were reviewed.

Although it was suggested that replies to Q.22 be kept in view this does not appear to be very relevant at this stage.

In the above replies, answers to other questions are cross referred to avoid duplication and reference may need to be made to them as well. Due to the pressure of time to prepare this report, other replies have not been fully reviewed as yet but will be as we go into further detail.

**2. Other Materials Reviewed**

Reference has so far been made to :

Chapter 3 – A. Benjamin – A Proprietary Law Analysis of the International Securities Market

[2005] LMCLQ 467 – M.Ooi – The Hague Securities Convention : a critical reading of the road map.

The Hague Convention – on the Law applicable to Certain rights in respect of Securities held with an Intermediary.

## Process -

1. It is understood that the focus of this review should not be to replicate the analysis of the **Hague Convention** drafters which looks at the issue from a Private International Law point of view. The Hague Convention seeks to develop rules which help us come to *the applicable law* relating to defined situations involving securities held through intermediaries.

Article 2.1 states some relevant issues on which the private international law rules in the Convention will help identify an applicable law. The most relevant ones from the perspective of THIS Report are routes towards finding the applicable law on :

*“(a) the legal nature and effects against an intermediary and third parties of the rights resulting from a credit of securities to a securities account;*

*(b) the legal nature and effects against an intermediary and third parties of a disposition of securities held with an intermediary;*

What the Convention does not address is the rules of private law in the legal system which has been selected as the applicable law. The focus of the exercise of the Legal Certainty Group is specifically the private laws in the EU which may be applicable.

Consequently while the discussions relating to the Hague Convention can be very instructive and useful, it is considered that the Convention is of limited relevance to us as we are trying to rationalise the selected applicable law itself and not the routes to it.

2. In the preliminary discussions it was mooted whether the EU has any interest at all in doing anything more than define routes to the applicable law in inter EU cross border situations, given that the private law on securities and the rights between investors and intermediaries and the rights of third parties are really domestic issues on which the EU has no mandate. Without in anyway wishing to enter into this kind of discussion it suffices to record that the general view was that the EU has an interest in this subject because the legal uncertainty in this context is creating barriers to the development of the internal market. It is also reducing efficiencies in the market as a whole. [Martin to re-draft if wrong].

3. In discussions it was also mooted whether what we should be trying to do is define minimum standard of law which have to be observed in all EU states to ensure that barriers are removed and whether we should seek to harmonise the private law of the Member States on the relevant issues. [ I do not know what was decided and what

mental attitude we should take in thinking about solutions to the problems we have?? Martin can you help? I ask because I need to know what mental approach to take even if we do not say it out loud....]

4. From preliminary discussions it was also evident that almost ALL EU member states had already grappled with the relevant issues relating to the holding of securities by an intermediary, mostly following the PRIMA rule and hence seriously reducing the legal uncertainty because it is acknowledged that a major part of the legal uncertainty is exactly the lack of clear rules on the applicable law. When the Hague Convention is enacted, if all EU states adopt it, there will be certainty in that regard. At least through the Convention all the state laws will refer to the same private law based on the same connecting factors and one will avoid diverse referrals or renvoi.

5. However it was recognised that having several private laws which can apply **at the same time**, as a result of clear private international rules, to **different** issues relating to securities transactions it a cause of uncertainty in itself and therefore needs to be addressed.

6. This Report therefor seeks the following :

- (a) to show that the private laws of the EU members states result *in different legal effects* to the holding of securities by intermediaries through book entry systems;
- (b) to consider which effects are common and which are different or conflicting;
- (c) to consider which effects are most desirable;
- (d) to consider how these can be implemented.

## **Brief Analysis of the legal effects in the Private Law of the 25 EU states based on the EU Legal Certainty Group's responses to the Questionnaire**

### ***Part 1 - Preliminary***

1. The following analysis is based on the information in the responses to Q. 7 and Q.12 and is not to be taken as a definitive state of the law in the states referred to. It is expected that the contributors from each state will verify the analysis before proceeding further.
2. It is evident that we have here a very difficult and ambiguous legal problem. The fact that the private laws of the 25 EU states have all adopted *varying legal solutions* - albeit grouped into around identifiable trends – confirms that the problem or problems which we are all seeking to solve are indeed very serious but more importantly that they present very problematic issues of characterisation.
3. The divergence in the trends can be mostly put down to the underlying legal systems and the Common Law based systems produce different solutions to the Civil Law systems for the obvious reasons attributable to how they characterise the holding of assets by one person for another. Broadly we can refer to the trusts and non-trusts divide which is most relevant in this area of law. A legal system solves its issues consistently with the underlying body of rules<sup>1</sup>.

### *Multiple angles to the issue*

4. The matter is made more complex because we do not have only one issue here but many issues arising from the same fact of an intermediary holding assets for another. The same factual context can be seen from the following angles:
  - (a) the effect of the book entry between the intermediary and the customer who is an investor;
  - (b) the effect of the book entry between the intermediary and the customer who is another intermediary;
  - (c) the effect of the book entry between the intermediary and the investor who is NOT the customer;
  - (d) the effect of the book entry between a pledgor and a pledgee of the asset;

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<sup>1</sup> Interestingly in a couple of cases, such as with Germany, the solution adopted seems to borrow in part from the trust law though there may also be a problem of linguistics in that the terms for “trust” and “fiduciary obligations” can be linguistically interchangeable and it may not be the case that the use of the term “trust” actually produces the same set of legal effects in Germany as it does in the Common law.

- (e) the effect of the book entry between a transferor and a transferee;
- (f) the effect of the book entry between any one of the above and a creditors of any one of the above.

It is evident that the appropriate solution to the legal issues differs from one factual context to another.

5. Again, the complexity arises because of the ambiguous nature of the “asset”. While we all know we are referring to investment instruments it is evident that laws characterise the “asset” in different ways, mostly to suit the solutions to the issues mentioned in the preceding paragraph 4 in a rational and consistent manner.
6. To complete the circle of complexity on the nature of legal relationships and the nature of assets it is then evident that the holding institutions – the depositories or custodians or intermediaries - enjoy different status in different states and the legal effects of holding by them differs not because the visual of the holding is any different but because substantively they have different purposes/functions and the laws apply distinct effects to certain holders.
7. The end result of the above is problems – and solutions - to the power of at least 3! It is desirable that the basis of the issues be reduced as much as possible.
8. It is evident that as a matter of process we have to follow routes which simplify the factual contexts and the analysis of them. Existing analysis has correctly concluded that there are tensions in legal policy in this area as two conflicting policies battle for dominance : the protection of ownership and the efficiency of the markets.<sup>2</sup>
9. The protection of ownership rights would militate towards rules of recognition of proprietary rights to securities in favour of the investor, more direct rights to vote and to take decision and more protection against intermediary creditor and abuse with less protection to third parties dealing with the intermediary. The efficiency of the market would require finality of transactions in favour of third parties in good faith even at the cost of the owner’s rights, greater legal integrity to actions by intermediaries who appear to be owners of record.

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<sup>2</sup> See Chapter 3 – A. Benjamin – A Proprietary Law Analysis of the International Securities Market, at page 75;

10. A policy decision must be taken on which one to choose as the primary guiding principle as that will determine the solutions one adopts in various cases. It is also evident that solutions must be consistent with basic legal principles of the EU and the Member States.
11. Consideration should also be given as to whether we should extract a set of rules which are consistent with the rules as they apply to material registered securities around which the basic rules we tend to apply have originated or whether we should apply different solutions due to the fact that although these are both “securities” or “interests in or to securities” we have a totally different situation to deal with here. The relevance of this issue is that it has constrained thinking to a large extent. The reality is that we have many more variations possible in the dematerialised book entry world as we can have investor specific or registered accounts and client/pooled or omnibus accounts while in the material world we can have registered or bearer instruments. It is very difficult to apply rules developed in one sector to the other and remain consistent.

## ***Part 2 - Intermediaries***

1. It was quickly realised that the proliferation of intermediaries raises many problems because of multi-tier holding which is hardly a problem in the physical world although it can exist theoretically. This opens up the possibility that a “customer” in one case is the owner and in the other case is a “service provider” and that provokes different rules depending on the TYPE OF CUSTOMER.
2. It was also noted that the TYPES OF INTERMEDIARY differ and they have different legal status and functions and the legal effects of book entries by them are different from the legal effects of book entries by others.
3. It is evident that some operators of book entry systems are “holders for customers” while others are not and only act as “registrars” only and do not hold per se. The legal effects of an entry into the former differ from an entry in the latter. It appears that the concept of a general or specific market depository or depositories - the CSDs, Crest etc. - is common to many States. That kind of depository is hardly a “holder” of securities but carries out a particular authenticating function.
4. A review of the Replies shows that in Europe (see Appendix A) we have three basic positions:

- (a) systems where they treat all intermediaries in the same manner and all book entries result in the same legal effects vis a vis the customer<sup>3</sup>.
- (b) systems where they have a legally recognised institution/s the book entries of which create special defined legal effects. There are several variations of the legal effects. See Appendix B<sup>4</sup>. In these systems when the book entry is NOT with these legally recognised institution/s the legal effects are different. There are several variations of the diminished effects. See Appendix C<sup>5</sup>.
- (c) Systems which have *more than one* legally recognised institution and different effects apply depending on by which institution the book entry is made.

5. It is evident that the above diversity is a cause of complexity on its own. The options we have are :

- Leave the situation unchanged and allow full freedom for this diversity;
- categorise **two** types of depositories/intermediaries - which need to be kept functionally apart - each producing defined effects when they have book entries : the holders and the authenticating registrar institutions<sup>6</sup>. The CSD type of depositories should be relatively easy to regulate because their functions are limited, complexity is reduced and legal effect of entries in the register should be easy to define. The focus will then be on the next level of “holders” who have book entries for their own customers where we start to see a issues on multiple effects (ownership rights vis a vis issuer and intermediary, intermediary rights and duties towards customer, etc). This solution would entail more or less rationalisation in EU member states depending on which type of system they have.
- Treat all holding intermediaries in the same way under one set of rules. This is the most effective as the system will be one and consistent -

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<sup>3</sup> These systems do not seem to have addressed the problem of multi-tier intermediaries and treat the “customer” at each level in the same way and then categorise them as “owners” or “fiduciaries” in the private law depending on the case;

<sup>4</sup> I need someone to build up Appendix B;

<sup>5</sup> I need someone to build up Appendix C;

<sup>6</sup> This might not be a good term but we see CSDs which serve to immobilise and dematerialise an issue of securities for future trading;

however the nature of the registrar type depositories (which are hardly depositories) may not permit this option commercially.

6. It is evident that among the “holding” intermediaries there are those who safeguard and those who manage, however this is a detail of contract on which the parties are free to agree and this should not impact on the legal effects of book entries with them. The law should not impose any limitations on what an intermediary could do once he is entrusted with securities and that will emerge from the service offered and taken and the contract signed between the parties.

### **Part 3 - Legal effects of book entry with CSD type book entry operators**

(This will be based on results in Appendix B which I have not yet compiled but intend to approach as with Appendix A)

### **Part 4 - Legal Effects of book entry with holding intermediaries**

(This will be based on results in Appendix C which I have not yet compiled but intend to approach as with Appendix A)