

LEGAL CERTAINTY PROJECT

PART I - SCOPE*

Indirect holding systems have replaced most direct holding systems in today's securities markets. Traditionally, financial instruments have been held under direct holding systems. Under such systems, investors in financial instruments had a direct relationship with the issuer, either because they were registered in the records of the issuing company or because they – personally or through their custodian – held physical certificates representing securities.

Under the traditional system of direct holding, transfers of financial instruments were necessarily made by physical delivery thereof in paper form, which made such operations laborious, complex and costly in time and resources. Such operations also involved serious legal risks since financial instruments in physical form had to be moved about and, consequently, risked loss, theft or falsification. In view of these disadvantages, the practice of holding and transferring financial instruments has been evolved world-wide. Nowadays, the vast majority of financial instruments previously held in direct holding systems have been displaced by those held in indirect holding systems. Any physical holding of financial instruments, to the extent it still exists, is centralised in special institutions such as central securities depositories, which, to a large extent, are the final and direct holders of the financial instruments within the chain of intermediaries.

Under the newly created holding pattern, an investor no longer has a direct link with the issuer and no longer has direct, physical possession of a certificate – if any – representing the financial instruments. The investor's right in respect of financial instruments is entered into the register or books of a financial intermediary who, in turn, is either directly related to the issuer i.e. as a holder in respect of financial instruments in the books of the issuer, or has his right registered or booked with another financial intermediary, i.e. as a holder in respect of financial instruments in the books of the issuer's account administrator or holding the physical certificates or any other document representing the financial instruments.

* The following text has been prepared by Dimitris Tsibanoulis as "reviewer" of the Report regarding the evaluation of questions 1-4 of the Questionnaire, further to the Preliminary Report of Ignacio Gomez Sancha of 26.1.2006.

Indirect holding systems have established a complex market infrastructure and sometimes may involve a very complex chain of intermediaries. The rights in respect of financial instruments are only recorded as book entries at the various levels of this chain of holdings. The interaction of different laws, which are sometimes even based on different legal traditions, governing all players in the chain between the issuer and the investor, through all intermediaries, in whose accounts securities are credited in book entry form, create a number of uncertainties and legal risks.

It must be noted that EU legislation does not regulate the prerequisites neither for book entries keeping nor for custodian services provision (that means providing book entries facilities and accounts custody services, i.e. keeping and administrating securities accounts in which rights in and on intermediated securities are registered). The perspective under which most member states developed rules regarding book entries keeping through CSDs and providing custodian services was local stock exchange driven and referred mostly to domestic issuers. Most national legislations provide that public traded securities issued by domestic issuers should be registered with the local, governed by specific legislation, CSD, for which often *lex societatis* property rights especially with respect to the securities issuers, are established.

Reason for this is the lack of links between issuers and CSDs governed by two or more different legislations, due to the fact that the member states company legislation governing the issuer, in the absence of harmonization, cannot establish rights and obligations regarding book entries kept by foreign account operators (intermediaries). This could lead to discriminatory treatment and consist a barrier in the free circulation of securities, since securities, to be admitted in the regulated market of an EU member state different than the member state of the registered office of its issuer (“foreign securities”), could be treated differently after their registration with the CSD linked with this regulated market than domestic securities, e.g. securities issued by issuers governed by the same jurisdiction as the one of the CSD. This could affect investors’ rights as well as issuers and intermediaries interests, creating thus an unacceptable barrier in the European financial markets.

As a matter of legal risk, the European member state jurisdiction which governs CSDs (and, in general, account operators) should not be a factor influencing the decision neither of an issuer regarding the regulated market, in which his securities will be traded nor of an investor regarding the securities he will acquire. That means that the rights deriving from a book entry in the operator’s accounts and their exercise should not constitute a discriminatory factor for

investor rights against the issuer depending on the jurisdictions governing the account operator and the issuer concerning the issues to be identified. In other words, the jurisdiction governing the book entry and holding of securities should not materially affect the legal certainty intrinsically linked with proprietary rights emanating from these securities in book entry form.

The rights of an investor, who holds securities in book entry form through an account operator or through a chain of account operators, against the issuer should not suffer from the interaction of the different European law systems governing the issuer and the intermediaries. That means that European law should cater for the removing of any existing legal and regulatory barriers that may directly or indirectly affect the investors' rights towards the issuer of the securities as well as their circulation due to the interaction of the different European jurisdictions governing the issues to be handled through European law.

For the promotion of the European single market, not only access to clearing and settlement systems throughout the Community by investment firms is required, but also the right of intermediaries to participate directly in other Member States' central securities depository systems settlement systems in a manner which guarantees the investors' rights, legal certainty and systemic stability. Community law should ensure that registration and book entries keeping with an account operator (or a chain of account operators) are effective erga omnes concerning the account holder, irrespectively of the EU-member state law governing the issuer and the account operators. This should facilitate the free circulation of securities within the EU, due to the fact that all EU registered issuers could open accounts held with any EU authorized intermediary and that investors' rights emanating from the securities would not be affected by the jurisdiction governing the intermediary, by whom they hold their accounts.

Thus, it will be ensured that the credit of securities to operators' accounts represents a good and effective interest and that any damaging uncertainty and systemic risk regarding the effectiveness of an interest represented by a book entry credit, or about the effectiveness and finality of a transfer made through book entry debits and credits would be eliminated.

The objective of creating an integrated financial market, in which investors are effectively protected and the efficiency and integrity of the overall market are safeguarded, requires the single European passport for account operators, concerning the function of book entries systems, through the establishment of common regulatory requirements wherever the account operators are authorised in the Community. These rules have to ensure the investors rights

and the systemic stability against systemic risk and legal uncertainty created under the involvement in the whole securities holding chain (from the issuer to the investor through the intermediaries) of entities governed by different European national jurisdictions. Both issuers and account operators should comply with all the relevant operational and commercial requirements of upper tier account operators (such as CSDs) for account opening or membership. Registration of securities with an authorized account operator should produce full authentication effects according to the law governing the issuer of the securities and to the extent that the account operator's rules are compatible with the holding model chosen by the issuer.

By regulating appropriately their company and securities law, member states, should make intermediated holding of European securities traded in European regulated markets possible through book entries with authorised European account operators. This statement should not be understood as an attempt of harmonisation of substantive legislations concerning company and securities laws. So, the recording/registration of securities in the accounts held by an authorised account operator should create the entitlement of the account holder towards the issuer according to the law governing the issuer. Furthermore, each member state may freely determine, regarding securities traded in domestic regulated markets and/or securities issued by domestic issuers, if, by recording these securities in an account operator (CSD), a) the possibility of registration in end-investor's specific accounts is offered or b) these securities would be held in fungible pools, operated by authorized accounts operators. Nevertheless, the first option should not prevent the holding of securities even through account operators in omnibus accounts, should it be the investor's decision. A typology of the main options regarding the form of the accounts held within the account operator should be established by community legislation. Any issuer may have the right to choose the account operator for recording book entries with respect to his securities to be traded in a regulated market, subject to the account operator's compatibility with the requirements imposed by the relevant jurisdiction according to the mentioned typology.

Aim of the proposed legislation is to remove legal barriers regarding the matters being identified in order a) to avoid the above mentioned discriminations and b) to ensure legal certainty and free movement of securities in book entries form within the EU. This effect should be succeeded irrespectively from the jurisdictions governing all the participants in the chain between the issuer and the investor, through all authorized intermediaries, until the intermediary in whose account are credited the investor's securities.

Therefore, the freedom of operating a book entry registry system as account operator should be introduced, subject to the authorisation of the relevant supervisory authorities of the home member state. Member States shall reserve authorisation as an account operator to those entities complying with the organisational and prudential provisions to be adopted through a Directive. Member States shall require the account operators to perform tasks relating to the organisation and operation of the book entry systems they keep under the supervision of the competent authority. They shall also ensure that the competent authorities continuously supervise account operators. Furthermore, the regulation of account operators should be restricted to issues relating to the holding and keeping of accounts in which securities will be registered. So, each CSD or, in general, account operator shall retain the right to determine the category of securities for which it opens and keeps accounts.

The regulation of an account operator would lead to the introduction of a new “investment activity/service”. This activity, related to the entitlement deriving from the registration of securities in accounts held with account operators and affecting issues relevant both to the issuer and the upper-tier intermediary, with regard to the rights of the investor, goes further from the “safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management”, which constitutes an ancillary service in MiFiDs Section B of Annex 1.

The proposed framework should a) abolish any kind of exclusivity, existing today in many member states, regarding the requirement to register domestic securities (from the issuers point of view) to a domestic account operator (CSD) in order to enable the trading of such securities in a domestic regulated market and b) facilitate the creation of links between issuers and account operators or between account operators themselves. Therefore, it enhances the integrity of European markets, increases investors’ confidence and reduces the transaction costs by providing cross-border investment services. The proposed legislation promotes the smooth circulation of securities traded in regulated markets and creates the necessary environment for a proper implementation of the MifiDs principles regarding the regulated markets. Thus, it contributes to the achievement of a fully integrated European financial markets and the level playing field.

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