

# Loiacono e Associati

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Re: **Legal Certainty Sub-group - Recognition of indirect holdings: a new legal asset?**

## MEMORANDUM FOR MARTIN THOMAS

The concerns expressed by legal scholars and practitioners, including members of the Legal Certainty Group, from certain EU member States governed by civil law legal systems (in particular France, Germany and Austria) in connection with the Unidroit project and the Hague Convention are understandable: civil law legal systems, especially in the area of financial law, should not a-critically introduce common law concepts that are systematically incompatible with principles deriving from Roman law and centuries of legal history and interpretation. The same concern has driven the creation of the European Master Agreement for derivatives, repo and stock lending transactions as a reaction to the imposition of the ISDA master agreement (and thus the application of English law and the election of English jurisdiction) by UK-based subsidiaries of US investment banks. The reason why the EMA project has substantially failed outside of Germany and possibly France would be an interesting topic for a separate discussion.

The second Giovannini report has clarified that the absence of a common framework for the treatment of interests in securities held with an intermediary constitutes the most important legal barrier to the development of a single European market in post-trading. The Legal Certainty Project is trying to identify the legal issues that prevent the creation of such a common framework. An initial comparative analysis has clarified that the most important of such issues is the different recognition and treatment of indirect holdings in the various European jurisdictions. Such different recognition and treatment appears to be the result of different legal traditions and the different manner in which the various jurisdictions have tried to cope with and adapt to the computerisation of securities custody, trading, and post-trading.

In all EU Member States the rules governing the deposit, trade, transfer and collateralisation of financial instruments are still shaped for paper-based securities markets. The certification of a claim against a company (with respect to fixed income securities) or of the ownership right of a piece of a company (with respect to equity securities) into a negotiable instrument represented by a piece of paper and the application of the rules of negotiable instruments to the transfer of, and disposition of rights with respect to, such piece of paper no longer make sense where such piece of paper is indirectly-held through a chain of intermediaries. In most cases the relevant negotiable instrument is not issued in paper form at all (in the case of dematerialised securities) or is artificially commingled with other similar negotiable instruments in one or more global certificates (in the case of immobilised securities). The comparative analysis has evidenced the incongruity of economic and legal reality: while the economic world trades and collateralises securities on the assumption that the same asset is being transferred or collateralised across jurisdictions, the legal reality is not so clear. The relevant EU jurisdictions variously characterise the object of the transfer as a claim, a chattel, an intangible right or a beneficial interest in a trust.

Legal certainty is incompatible with such discrepancies of characterisation. A single European market requires legal certainty as to what is sold, pledged and, especially, rehypothecated. In the

absence of the rehypothecation one could argue that the legal characterisation of the object of the security interest over an indirectly held security granted by A to B is determined by the jurisdiction of the relevant intermediary holding the security in custody on behalf of A; the legal characterisation of the object of the transfer from A to C is determined by the jurisdiction of the issuer of the security; and the legal characterisation of the object of the custody arrangement between C and its custodian after the above transfer has settled is determined by the jurisdiction of the relevant intermediary holding the security in custody on behalf of C, which might be different from the legal characterisation of the object of the security interest granted by A to B. In other words, in a world where a “static” dimension is clearly distinguishable from a “dynamic” dimension, Europe could live with such discrepancies of legal characterisation: thus if A pledges asset X to B when A transfers the security to C asset X disappears and reappears with a possibly different characterisation as asset Y. The important thing is that the object of the transfer is always the same and always has the same legal characterisation, irrespective of the jurisdiction of the transferor, transferee and their respective relevant intermediaries. The only important thing to clarify in order to obtain legal certainty is that the object of the transfer is or might be a different asset from the object of the security/custody arrangement.

However, in a legal environment, such as the current one, where we have introduced the US-style right of rehypothecation the above legal analysis no longer works. Legal certainty can only exist if the object of the pledge, transfer and rehypothecation coincide. My preliminary conclusion is that such coincidence can only be obtained by the creation of a new legal asset (*bien juridique, bene giuridico, Rechtssache*, to apply civil law legal concepts in the various languages) in all European jurisdictions, similarly to what Luxembourg and Belgium have already done in a rudimentary way and the US Uniform Commercial Code in a much more articulated way. Such legal asset should be the EU equivalent of the US securities entitlement or, as others prefer to refer to it, interest in securities or book-entry security. The introduction into the EU legal systems of such new legal asset should not be viewed as a further example of the “anglo-saxisation” of the European financial laws, but a realistic and pragmatic way to take into account that in modern finance claims against companies or ownership of pieces of companies represented by an electronic book-entry rather than a paper certificate.

If we accept that at least in the European Union, where securities transfers function more or less in the same manner, as Diego Devos has persuasively pointed out, every legal system should introduce the legal asset called securities entitlement defined, similarly to the view taken by US legal scholars, as a proprietary right consisting of the bundle of economic and administrative rights held by the securities account holder against its own custodian, we would solve many problems at the same time: the same asset would be transferred across the various EU jurisdictions (by way of sale, repo or rehypothecation) and the recipient of the transfer would hold exactly the same asset as the transferor.

Would the corollary of this be that a single and different asset rather than a multiplicity of the same fungible assets would be the object of the transfer or collateralisation and hence that certain arrangement requiring the fungibility of the object of the transaction in certain jurisdiction (such as the repo, the irregular pledge and the irregular deposit under Italian law) would be impossible, as professor Roy Goode has suggested in his latest publication on this subject matter? Not at all, because the securities entitlement grants the holder all and the same economic and administrative rights attaching to the relevant financial instrument. Thus, it would and should be irrelevant if the transferee enforces its securities entitlement through intermediary B or the transferor enforces it through intermediary A.

The creation of a new legal asset would ensure that there is legal uniformity as well as certainty in the European Union as to what is being transferred and collateralised. Before taking independent views on this complex subject matter at the UNIDROIT convention, EU Member States should first try to agree on a European common solution and only then force the Unidroit project to take such single European solution into account before taking any premature position. I suspect that the reasonable and rational solution for Europe would constitute the reasonable and rational solution for the entire world, given the fact that most legal systems derive either from the Roman law or common law legal tradition.

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