LEGAL CERTAINTY PROJECT

NOTES FOR A DRAFT PRELIMINARY REPORT: PART I, SCOPE.

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1. <u>Introduction: Scope.</u>

Following the path opened by the Giovannini Reports I and II, the Commission Communication "Clearing and Settlement in the EU: the way forward" stated that a crucial element for the creation of an integrated and efficient European capital market will be the safety and efficiency of the arrangements required to finalise securities transactions ("Clearing and Settlement"); and that without efficient clearing and settlement arrangements, the ability and willingness of participants to trade in EU securities will be sub-optimal; the liquidity of financial markets will be affected and the cost of capital will be higher than it need be.

As regards legal issues, the first Giovannini Report stated that *"The national legal systems relating to the nature of and dealings in securities have evolved to reflect the specific socio-economic culture of each Member State. In consequence, there is substantial diversity in the legal treatment of securities across the EU. While the law may be well understood by participants in any one national market**, the scope for complexity and uncertainty** in the legal treatment of securities where more than one jurisdiction is involved **leads to an inevitable lack of clarity for all**. Problems of legal complexity are set to intensify as securities transactions increasingly involve more than one jurisdiction. (…) Uncertainty is increased still further by the fact that securities themselves are legally complicated, not homogeneous, and vary widely in their legal characteristics."* The *absence of an EU-wide framework for the treatment of interests in securities held with an intermediary* was identified by the Giovannini Group as the most important source of legal risk in cross-border transactions.

When referring to the legal framework of EU cross-border securities clearing and settlement arrangements "uncertain" and "complex" are two adjectives commonly used. However, there is no such agreement as regards the substantive: "EU cross-border securities clearing and settlement arrangements". Everybody knows that these arrangements are essential, vital, for the Single EU Financial Market. Although the boundaries —the scope— of the concept are far from clear. As we will see below, when referring to the "scope" of our work, we will find that "uncertainty" and "complexity" are two faces of the same coin.

1.1 "Scope" as "uncertainty".

"Financial Market" is of course a wider concept than "Securities Market". "Dealings in securities" is not the same thing as "dealings in financial instruments". "Financial instrument" is generally conceived as a more general concept that includes securities —i.e., in Annex C of MiFID— and many other transactions over instruments that are financial in nature (this is to say, designed to allow financial exceeds to directly or indirectly reach those who are in financial deficit).

However, it is easy to identify that dealings in some securities that are undoubtedly such —i.e. public debt bonds—, may be cleared and settled in “arrangements” which are similar to, or that work under, analogous rules or means than those used for instruments which may not generally be perceived as securities, or even financial instruments. Therefore, the fact that a given instrument is included in a certain “arrangement” for the purposes of clearing and settlement is not a good path to set boundaries in our field (i.e. IBERCLEAR is in charge of the registry of emission rights of the Kyoto Protocol, which at first sight are not financial instrument in nature).

Several existing EU Directives —for example, SFD, FCD, IR, MiFID, TB—, contain rules that, directly or indirectly, affect or are related with this concept. None of them define what “EU cross-border Securities clearing and settlement arrangements” are. All of them define some of the words —clearing house, settlement, securities, etc.—. Moreover, all of them define the words for a particular purpose only. For the purposes of TB, securities are only such if they carry voting rights in a company, but are only such as regards MiFID, if they are included in a given laundry list.

Other initiatives —The Hague Convention and UNIDROIT— have opted for a “possibilistic” solution. Both processes have in common that they have left the finding of a definition for the end of the process: “First, let’s agree on how this should work, and then we will agree on what we are going to apply these new solutions or rules to”. They have ended giving a descriptive definition that ends with a “catch-all term” (for example, “securities” means any shares, bonds or other financial instruments or financial assets (other than cash), *or any interest therein*).

It is as if everybody knows what we are referring to, but nobody is able to give a good definition. And is quite obvious that asking a jurist to give a good legal solution to a given problem, without telling him what the problem is, or more accurately, what is the “scope” of the problem, or in other words, where does the problem end, is an insurmountable mission. If the problem is uncertain in itself, the solution will probably be uncertain also. If this were the case with the concept “EU cross-border securities clearing and settlement arrangements”, then the Legal Certainty Project’s only probable fate would be not to succeed.

1.2 Scope as “complexity”.

However, “scope” draws our attention to a second set of issues, which are those related to the fact that a given problem —i.e. the “nature of a credit to a securities account”, the “moment of transfer” or “priority rules in case of shortfall”— may not have a legal solution in a certain jurisdiction, or the solution may differ in different countries. Therefore, when the problem is not “domestic”, but “cross-border”, it involves a solution composed by more than one element, that is to say, a complex solution. The lack of legal harmonisation among the 25 EU countries, even when referring to an identical, certain, factual situation, creates an inescapable pitfall.

Some of these issues are very closely linked to the “uncertainty” part of the Scope. The reason being that the problem of delimiting “securities clearing and settlement arrangements”, (which will lead us to other concepts as “securities accounts” and “securities accounts providers”), this is to say, the first face of the coin, is also in the other side of the coin: they are defined in a different fashion in each country, or even worse, not defined at all.

1.3 Scope and the applicable law.

Both aspects of the issue of the “Scope” of our work have one thing in common: the starting point to solve them, the beginning —not the end— of the solution, is to determine under the applicable law: It is simply not possible to give a legal solution to an existing problem if it is not possible to predict the law under which the solution should be given, or at least the Courts would give it, if they are asked to do so.

However, we may side-step this mine with the following reasoning: the LCProject has not been asked to give a legal solution to existing legal problems. It has been asked to identify if and how there are legal barriers to an efficient and sound integrated financial markets and, should this be the case, how to tackle them and to propose potentially viable solutions.

Of course this approach, although pragmatic, on the one hand constrains very much the work of a jurist, and downgrades the calibre of the solutions to be proposed; and, on the other hand, it does not fully obviate the issue. That is way in our work we tacitly stick to the approach of the SFD and the FCD: the applicable law is the law of the location of the account, which is generally speaking the location of the office through which the account provider is acting in commercial terms, without prejudice to any polity decision to be taken by the competent authorities in this field.

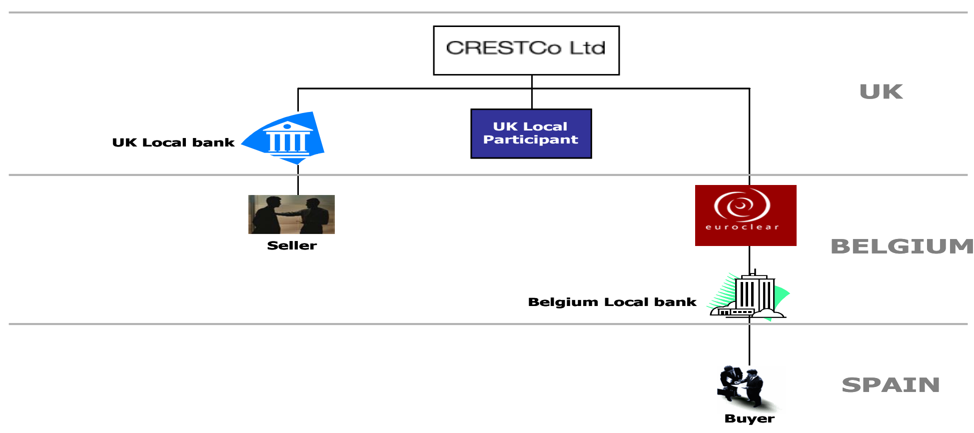
The bottom-line of our analysis is that there seems to be legal barriers that constitute real obstacles to finalise transactions over securities when done cross-border. Therefore, the common denominators are, of course, “securities” and “cross-border”, and we will start here.

2. <u>“Cross-border” does not mean “international” but “indirect”.</u>

A possible way to differentiate a domestic securities transaction from a cross-border securities transaction is that the latter involves securities accounts subject to different jurisdictions —please see below for the concepts “securities” and “securities accounts”—.

When setting up an organised securities settlement arrangement, the manager of such arrangement chooses to submit it to a given law. Credits and debits in the accounts opened by such account provider happen inside a given jurisdiction, despite the place of location of the account holders, which may or not be final investors.

As it is well-known, when the final investor (i.e., whoever is bearing the economic risk of the investment) invests abroad through a local intermediary, two accounts are used to "sustain" the same investment. Therefore, the delivery of the securities from the final seller to the final buyer may require more than one credit and one debit, each done by the relevant intermediary and subject to its applicable law.



However, the first point that should be taken into account is that this pattern —the intervention of several securities accounts subject to more than one law— is not enough to encompass all "cross-border" scenarios. The real border that, when crossed, causes problems, is not the border of a country, but the border of a "settlement arrangement". This arrangement may be a CSD with all its complexities, or may simply be a set of accounts opened by an intermediary, that is used by its clients to achieve settlement in an internalised way. Additionally, this arrangement may be composed by a "sole tier" system of accounts —tipically, the Nordic CSDs— or by a two-tier system —as is the case in Spain, where the CSD and its participants share relevant information for the managing of the system and together compose a single book-entry system—.

In some cases, like in U.K., certain settlement arrangements are very detailed as regards the settlement mechanics and procedures —i.e. through CREST internal regulations—, but when considering the legal nature of the assets credited to an account, the answer is not so straight-forward[1].

So the common pattern that may be found in any "uncertain" or "complex" securities scenario is that there is someone that participates in a settlement arrangement, in a broad sense, but is acting for someone else, this is to say, as an intermediary or account provider on behalf of a third party. The third party —the final investor always, or another intermediary— gets to be an "alien" to that arrangement, because it is

1 There are four potential answers, according to "The FMLC Report on Property Interests Indirectly Held in Investment Securities….", 2004.

outside its borders. Should we stress that this “arrangement” may simply be a set of securities accounts opened by a single bank.

In sum, the uncertainty and complexity is created by indirect holdings, despite the law that is applicable to each tier of holding. If a U.K. resident opens an account in the Nordic CSD, although economically is a foreign investment, it is not for the purposes of our study. By way of another example, in Spain there is no regulation for holdings that are maintained inside Spain, but outside the CSD. This is a clear case of holdings subject to uncertainty and complexity, but inside the borders of one country. And the cause is not legal diversity, but the lack of regulation of indirect holdings.

> PRECISION: To understand why “indirect” holdings are badly regulated in most of EU countries is necessary to go back a little bit. Book-entry systems where created to substitute a previous legal arrangement that legislators had created to regulate a direct relationship between issuers and investors. That “legal arrangement” was —still is in many places, in particular for non-listed securities— paper certificates representing, evidencing or being by itself, securities.
>
> When paper certificates appeared, they were a great solution for a then existing problem. From an economic standpoint securities where created because investors gave money to issuers, becoming their creditors. Therefore, investors were a type of creditors, and securities where, from an economic standpoint, credit rights. This credit rights were composed by a wide array of “legal powers” in the side of the investor: to obtain dividends or coupons, to vote, etc.
>
> Of course any investment demands liquidity, and it was necessary to allow investors to transfers their investment to third parties. But transferring credit rights is always a difficult issue, as: (i) the transfer or assignment should not put the debtor in a worse position (for example, the normal debtor would not be happy to loose the capacity to set-off its debt with a credit right that he may have against its investor-creditor. On the other hand, a third party would never agree and acquiring a security that is vitiated by the threat of a set-off against the debt of a previous creditor); (ii) the transfer should not be opposable to the debtor by the new creditor without the latter knowing that such transfer had occurred, etc. So the speed and certainty demanded by a securities market led to the creation of a new means of transferring such credit rights: by transferring a paper that represented, evidenced or was itself the security, and that gave the holder a right against the issuer *autonomous* from the right that the previous investor had. As it may be seen, this scheme involves a direct relationship between the issuer and the holder of the paper, whoever this was in a given moment. If the holder were to give a right over such security, this would generally constitute a different legal scheme in which the issuer would not be involved. So the “circulation scheme” of securities as credit rights was substituted by another circulation scheme more akin to movable property, based on physical delivery, and without the need to give notice to the debtor-issuer.
>
> In this situation, if the holder of the certificate were to give a right or interest over the paper-based security as the “underlying asset”, in many jurisdictions no one would think

of this person as an “indirect shareholder”, but as having some kind of claim against the holder of the paper.

In other jurisdictions, like the U.K., the scheme has not been based in incorporating rights into papers, but on another sort of legal arrangement, like the trust concept or other akin to that, but with the same effects: the acquiror acquires a “novated” right which may not be prejudiced or affected whatsoever by whatever happened before between the issuer and the transferor.

When the “paper-crunch” occurred in the late ‘60s, it was seen that technology could help very much with speeding up the transfers. And the rest of the story is well-known (see to this effect the First Giovannini Report). However, the important point for our purposes is that those book-entry systems were created to avoid the movement of paper, not with the specific intention of accommodating foreign investments, or investments through an interposed person.

In fact, these “settlement arrangements” were built up in a moment when the markets where local. So, generally speaking, their legal fundamentals are solid when analysed in a local environment. Additionally, those arrangements are conceived to cater not only the needs of the transfers and dealings among investors, but also between the issuer and each investor, by way of establishing coordination with Registrars, etc., for *lex societatis* purposes. This is the case of national CSDs as regards clearing, settlement and registry of domestic transactions, as is very well pointed out in the Giovannini reports.

However, market practice is always ahead of the law, and investing in securities is done through financial intermediaries for well-known reasons. These intermediaries may, or may not be part of the “settlement arrangements” available for finalising securities transactions. If they are not part of them, then an intermediary that in fact is part of the said arrangements becomes necessary. And this is when uncertainty and complexity show up again.

So we have a proposal to find one of the variables of the equation “Scope” regarding “EU cross-border securities clearing and settlement arrangements”: a securities transaction is cross-border when finalising it requires the intervention of an account provider crediting or debiting indirectly held securities.

3. The problem of delimiting a common concept of “securities”, “securities accounts” in an EU environment.

As it has been said, a significant part of the legal uncertainties that fall inside the scope of our work comes from the fact that the same concepts are defined and treated very differently in different countries.

3.1 Securities

Within the European Union, there does not exist a uniform legal concept of "securities". The terms and definitions that exist in the 25 EU Member States differ sometimes significantly. Whilst in several groups of countries, comparable principles are applied, the concrete details differ in a way that it seems unadvisable to categorise jurisdictions in specific families or clusters.

Traditionally, in many countries the notion of securities had been developed for general civil law or corporate law purposes. These concepts are usually contained in the civil codes or securities acts. In those cases, the definitions of securities tend to be abstract, although accompanied in some instances by an additional exemplary or enumerative list of specific types of assets falling under the notion of securities. The scope of these definitions generally encompasses shares, bonds and other similar negotiable instruments. In some instances, the scope of the definition is wider, encompassing for instance bills of exchange, promissory notes, cheques or mortgage bonds.

More recent legislative activities in the area of capital markets law have led to the introduction of new concepts, taking into account financial market developments and practice. Given the rapid innovation in the financial markets, new definitions had to take account of a wide variety of new categories of assets that had been created in the capital and money markets. The main such types of assets are money market instruments, certificates of deposits, units in collective investment undertakings and other fund units, certificates giving the right to acquire shares or bonds, as well as certain categories of derivatives such as futures, forward rate agreements, swaps or currency options. As a rule, these new legal acts do have a limited scope, usually focused on the areas of issuance and trading of such instruments.

Regarding the latter, some degree of European harmonisation can be identified, due to the existence of relevant EU Directives, namely the Directive on Markets in Financial Instruments (2004/39/EC) of 2004 (MiFID)[2], which is due to replace the Investment Services Directive (93/22/EEC) of 1993 (ISD)[3].

a) Impact of MiFID and ISD

The MiFID defines "financial instruments", "transferable securities" and "money-market instruments" (Art. 4 (17-19)[4]). Already the ISD contained, albeit simpler, definitions of "transferable securities" and "money-market instruments" (Art. 1 (4, 5)[5]).

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2 OJ L 145, 30 April 2004, 1 ff.

3 OJ L 141, 11 June 1993, 27 ff.

4 "17) 'Financial instrument' means those instruments specified in Section C of Annex I; (see below)

18) 'Transferable securities' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;

(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;

(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;

Whilst being geared primarily at the trading side of securities transactions, a number of the MiFID provisions have a bearing on the clearing and settlement infrastructure (e.g. regarding the safekeeping of client's assets and the access of investment firms to central counterparties and clearing and settlement facilities). In respect of the former, Member States will have to set up a "single passport" system enabling investment firms to operate throughout the EU. The authorisation from the home Member State may also cover ancillary services, such as "safekeeping and administration of financial instruments for the account of clients" (Art. 6 (1)). Furthermore, with respect to safeguarding client's assets, Article 13(7) of the MiFID states that an "investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard client's ownership rights". Under Article 13(8) of the MiFID an "investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights".

Given that EU Directives require transposition measures by the Member States, the new concepts have been introduced sometimes by altering existing definitions of securities, sometimes by establishing alternative definitions of securities for specified

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19) 'Money-market instruments' means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment".

"Section C - Financial Instruments

(1) Transferable securities;

(2) Money-market instruments;

(3) Units in collective investment undertakings;

(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

(8) Derivative instruments for the transfer of credit risk;

(9) Financial contracts for differences.

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls."

5 "4. transferable securities shall mean:

- shares in companies and other securities equivalent to shares in companies,
- bonds and other forms of securitized debt which are negotiable on the capital market and
- any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement excluding instruments of payment;

5. money-market instruments shall mean those classes of instruments which are normally dealt in on the money market"

"SECTION B - Instruments

1. (a) Transferable securities.

(b) Units in collective investment undertakings.

2. Money-market instruments.

3. Financial-futures contracts, including equivalent cash-settled instruments.

4. Forward interest-rate agreements (FRAs).

5. Interest-rate, currency and equity swaps.

6. Options to acquire or dispose of any instruments falling within this section of the Annex, including equivalent cash-settled instruments. This category includes in particular options on currency and on interest rates."

purposes and sometimes by introducing new terms such as financial instruments or investment property. As a result, there is now a wide variety of concepts.

The national concepts in some countries are a direct reflection of the ISD terminology (the MiFID is still in the process of implementation). Others correspond broadly with the terms, however with sometimes significant divergences in the context of assets transferable by book-entry. By way of example, UCITS are often included in the national definitions, whereas the definitions of "transferable securities" in the Directive do no include UCITS.

Finally, in a few countries, further categories of definitions have been developed especially for the purpose of regulating the settlement of securities and other financial instruments or the holding of such assets on a fungible basis. Here, further types of assets such as depository receipts or certificates representing a trust relationship (e.g. in respect of foreign shares held by an intermediary as fiduciary trustee) are covered.

b) Legal basis for the definition of "securities" or equivalent terms

In a number of EU countries, there is a single legal source containing the definition of "securities" or equivalent terms[6].

Some of the relevant definitions are in an abstract form with an exemplary list of types of assets (Slovakia, Finland) or refer directly to the MiFID[7].

In a majority of the EU countries, relevant definitions of "securities" or equivalent terms are contained in two[8] or more[9] legal acts. The scope of the respective laws may vary according to the type of transaction or the type of issuer.

Some of the countries have chosen abstract general definitions[10], or have abstract general concepts, e.g. in a civil code or securities act, with enumerative lists of the types of assets eligible in a capital market context[11], others have only such enumerative lists[12].

In some countries, a general legal definition of securities does not exist[13] or is a matter of academic doctrine[14], however, with specific definitions contained in capital market related legal acts.

6 Denmark, Cyprus, Latvia, Lithuania, Portugal, Slovenia, Slovakia, Finland, Sweden

7 Slovenia

8 Czech Republic, Hungary

9 Belgium, Czech Republic, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Luxembourg, Hungary, Malta, Netherlands, Austria, Poland, United Kingdom

10 Estonia, Luxembourg

11 Germany, Estonia, Greece, France, Hungary

12 Netherlands, Poland

13 Spain

14 Austria, United Kingdom

It is noteworthy, that some countries have an explicit definition of securities eligible for securities custody and settlement, usually in a deposit and custody act[15], in laws establishing intermediated securities holdings[16] or establishing a domestic central securities depository[17].

As a rule, domestic laws seem to distinguish between different relevant definitions (such securities, transferable securities, financial instruments or other genuine terms), depending on the context. However, the use of these terms is not uniform.

c) Material scope of the definitions

In all EU Member States, to the extent that assets are concerned which are eligible for intermediated holding and transferable by book-entry, the notion of securities or equivalent terms seems to encompass certain types of assets. These are shares and similar types of equity securities representing a participation in a company that are negotiable in the capital markets (mostly excluding participations in limited liability companies or partnerships), and bonds and similar types of debt securities representing a right to receive repayment of an outstanding amount that are negotiable in the capital markets.

Often, express reference is made to securities that give the right to the acquisition of the previous two types of securities (i.e. shares and bonds type of assets)[18]. Other statutes refer in a catch-all format to other securities or financial instruments, to the extent that they are fungible and/or negotiable in the capital markets[19].

Furthermore, a majority of EU countries has included specific other types of assets in the notion of securities or equivalent terms. The most relevant ones seem to be money market instruments (i.e. instruments that are usually traded in the money markets, such as short-term paper, medium-term notes or certificates of deposit)[20] and UCITS (units in collective investment undertakings) funds[21]. Some countries refer expressly to other types of mutual funds or fund units in general[22].

Other types of assets that are explicitly referred to by national law as a subset in the context of defining securities or equivalent terms are warrants[23] or mortgage bonds[24].

15 Germany, Austria

16 Belgium

17 Slovenia

18 Czech Republic, Denmark, Estonia, Lithuania, Luxembourg, Slovakia, Finland

19 Belgium, Spain, Austria, Poland, United Kingdom

20 Belgium, Czech Republic, Denmark, Germany, Italy, Latvia, Lithuania, Luxembourg, Hungary, Malta, Austria, Poland, Slovenia

21 Czech Republic, Denmark, Germany, Estonia, Spain, France, Italy, Latvia, Lithuania, Malta, Poland, Portugal, Finland

22 Estonia, Poland, Slovakia, Finland, Sweden

23 Czech Republic, Germany, Poland

24 Denmark, Spain, Austria, Poland

Some types of assets that are often included in general definitions of securities (e.g. bills of exchange, cheques, promissory notes) do not seem to be of relevance in the context of intermediated holding and transfer by book-entry.

It is noteworthy that in some jurisdictions, instruments that have been developed for settlement purposes are expressly included in the respective definitions of securities or equivalent terms, namely depository receipts[25]). In one country[26], special instruments, i.e. certificates representing a trust relationship in respect of foreign shares held by an intermediary as fiduciary trustee are considered to be securities in that sense as well.

Remarkably, only two jurisdictions[27] refer expressly to equivalent foreign securities.

Finally, it should be noted that in a few instances, other instruments might be included in existing definitions on a case-by-case basis by the competent authority[28].

d) Distinction between bearer and registered securities

Traditionally, the distinction between "bearer" and "registered" securities relates to the mechanisms by which ownership is evidence or by which transfer of the rights embodied in papers takes place, respectively, by virtue of delivery of the document or by virtue of a registration either on the document (endorsement) or on a register.

As regards bearer securities, the person entitled to the security and to the rights represented by the security was deemed to be the bearer, i.e. the person holding (physical) possession of the security. Consequently, transfer involved the delivery of the security.

As opposed to that, registered securities are in the name of a person. However, the way this is implemented may differ between jurisdictions, and accordingly there is no uniform use of the terminology of registered securities. The nominative element could be constituted either on the security itself, in which case transfer occurred through endorsement and handing over of the security (these securities are in some jurisdictions referred to as order securities). Or, the name of the person entitled to the security is contained in a register, which used to be maintained by the issuer.

With the introduction of book-entry systems for the holding and transfer of securities, these original concepts have changed their relevance.

In some countries, at least in the context of indirect holding of securities through book-entry systems, no distinction between bearer and registered securities exists anymore[29].

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25 Germany, Greece, Lithuania, Netherlands, United Kingdom

26 Germany

27 Czech Republic, France

28 Denmark, Estonia

To the extent that systems are based on registration, this register may now in some countries have to be maintained by designated institutions such as a central securities depository or central register[30].

Moreover, if a book-entry system is a "direct holding" system, the distinction may become obsolete to the extent that the name of the ultimate owner has to be recorded in respect of any holding of securities.

However, even with the introduction of book-entry systems for the holding and transfer of securities, many countries maintained this traditional distinction between securities in registered form or in bearer form[31]. Within a book-entry system, this may result in differences as to the recording of the name of the investor, whereby the owners of bearer securities may be identified in the chain of securities accounts providers.

Furthermore, even after the establishment of book-entry systems for the holding and transfer of securities in electronic form, some jurisdictions continue to require the maintenance of a parallel share ledger or a register of registered securities on behalf of and for the account of the issuers[32].

Finally, in some countries, there are limitations as to the possibility of issuers to choose the type of specific securities, as some types of securities (for instance corporate shares) must be issued in registered form[33]. In addition, in a number of countries, for specific listed securities, they have to be in registered form[34].

e) Distinction between physical and dematerialised securities

Traditionally, securities have been issued in physical form, as individual certificates. However, with the increased use of intermediation in the area of clearing and settlement of securities, this has led to cumbersome procedures and delays. In order to overcome these problems, the practice in modern securities markets took account of the impact of modern information technology, by increasingly using electronic means to represent holdings of securities by way of book-entries. This was accompanied by legislatory changes, which did legally acknowledge the issuance and holding of securities in paperless book-entry form.

Two main strands of developments can be noticed. One the one hand, physical securities are delivered into a specialised entity, usually a central securities depositories and remain there immobilised, either as individual certificates or in the form of a global note. One the other hand, securities can be either delivered into

29 E.g. Belgium, Cyprus, Latvia

30 E.g. Czech Republic, Estonia, Slovenia

31 Germany, Greece, France, Ireland, Italy, Luxembourg, Austria, Poland, Slovenia, United Kingdom

32 E.g. Ireland

33 E.g. Italy

34 E.g. Greece

specialised entity, usually a central securities depositories or central register and then canceled and replaced by an electronic registration or alternatively already issued in such entity in purely electronic form. Both variants allow for subsequent transfers by way of book-entry.

Here, it is noteworthy that in a few countries, general law seems not to distinguish between physical and dematerialised securities[35].

As of today, in most EU countries, there is a legal regime allowing for dematerialisation of securities[36]. However, the scope of application of these regimes differs considerably, sometimes being mandatory, sometimes being limited to specific types of issuers.

In one country, all securities have to be in dematerialised form and are required to be registered in an account by way of book entry[37].

In a few countries, all securities that are in public circulation or publicly traded have to be dematerialised[38].

In some countries, all securities that are held within specific central securities depositories[39] or central registers[40] have to be dematerialised.

Furthermore, some countries require that in order to have specific securities listed on a regulated market, they have to be in dematerialised form[41]. This may entail as well mandatory inclusion in a specific central securities depository or central register.

However, some EU countries' laws do not provide for dematerialised securities[42] or only as a rare exception[43].

Dematerialisation may be limited to specific issuers, such as public entities under special legal regimes[44] or specific securitisation companies[45].

In the other countries, securities may still be represented by physical securities at the option of the issuer. In those instances, where securities eligible for book-entry

35 Belgium, Cyprus

36 Belgium, Czech Republic, Denmark, Germany, Estonia, Greece, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, Austria, Poland, Slovenia, Slovakia, Finland, Sweden, United Kingdom

37 France

38 Poland, Latvia

39 Denmark, Cyprus, Lithuania, Malta, Slovenia, Slovakia, Finland, Sweden

40 Czech Republic

41 Greece, Italy, Malta, Slovenia, Sweden

42 Netherlands

43 Austria

44 Belgium, Germany, Austria

45 Luxembourg

transfers are still represented by immobilised certificates, securities of a kind may be embodied in a single global certificate[46].

f) Derivatives.

Derivative instruments are often not contained in the general concept of securities[47], but are usually included in the notion of financial instruments[48]. The most regularly cited types are futures, forward rate agreements, swaps and currency options. In some countries, derivatives are only considered as securities if they are issued in paper form[49] or publicly[50].

An important issue to be tackled is whether the identified legal barriers for finalising cross-border transactions on securities exist also for transactions on derivatives. This is to say, if we should tackle "EU cross-border derivatives clearing and settlement arrangements".

The answer to this question requires climbing up the holding chain. Derivatives may be classified, from an economic point of view, in two big families:

(i) Bilateral derivatives which may not be treated as "securities", i.e. because they are mere contracts between two or more parties the terms of which are negotiated between them, and therefore tailored at will. In this case there is no "issuer" of securities. Many jurisdictions treat them as financial instruments for certain purposes (i.e. as part of a master agreement in which close-out netting is possible in accordance to the legislation implementing the FCD). By nature, they are credit rights, and its transfer follows the path of an assignment of credit rights or obligations. The law applicable to this assignment should be determined under the Rome Convention of 1980. Of course, banks and other counterparts use "book-entries" in "accounts" to identify and control this kind of contractual arrangements —i.e. to calculate the maximum credit-risk exposure against a given counterpart in net terms—. But this is nothing different to other type of instruments designed to cover financial risk bilaterally.

(ii) Derivatives created and traded in an organised environment. They are financial instruments characterised by the fact that the investor has no power to negotiate the terms and conditions of such instruments, which are typically designed by an organised derivative market that offers them (some say "issues them") for trading, and then usually there is a central counterparty that interposes itself between every buyer and seller *ex-ante* or through novation, acquiring the responsibility to fulfil the obligations as principal. Another common characteristic is that these

46 E.g. Germany, Austria, United Kingdom

47 e.g. in Spain, United Kingdom

48 Belgium, Czech Republic, Denmark, Spain, France, Latvia, Lithuania, Malta, Slovakia, Sweden, United Kingdom

49 Germany

50 Finland

derivatives are frequently tailored to cover the exposure to other financial instruments that are traded in an organised fashion (i.e. equities and debt spot markets). Certain jurisdictions state that these derivative instruments are subject to the same "circulation scheme" as securities represented by means of book-entries (i.e. Spain).

The suggestion would be to include the second group in the scope of our work, leaving the first aside. This distinction would not be necessary provided that a good and comprehensive private international rule was in places, as this rule would tell us whether these instruments should be treated as securities or as mere credit rights.

3.2 Securities accounts.

Another cornerstone for our work is the concept of "securities account". It is of paramount importance because securities accounts are intuitively believed to be "where securities inhabit".

Some jurisdictions have built "strong houses" because the legal environment requires securities to be protected in a certain fashion; consequently, securities accounts form part of a "registry of property" system, and are not a mere evidence of a contractual obligation; they are the elements (cells) that make up the book-entry registry of securities held by means of book-entry. In these accounts the relevant inscriptions over securities take place, producing material or substantive effects between the parties involved –*inter-partes*– and against third parties –*erga omnes*–. In this manner, the amount or number of securities published by the securities account goes beyond the existing legal relationship between the account holder and the account provider, because it has full authentication effects *erga omnes.* The legal consequence is that if one does not have his securities, or a given form of collateral, recorded in a concrete account, in a concrete technological format dictated by the manager of a settlement system, then he has no securities or collateral[51].

Other jurisdictions[52] seem to conceive securities as a species of a common gender, i.e. the trust, and therefore securities accounts are mere accountancy books where interest in a trust is recorded.

Finally, for some jurisdictions a securities account is nothing more than an account agreement that creates rights and obligations of the parties relating to the securities deposited with the intermediary[53].

The common grounds in every jurisdiction are that securities accounts are instrumental: they reflect the number of securities "owned" by the account holder, or otherwise "owed" to the account holder, depending on the legal nature of securities in

51 Spain, Poland, Greece, Czech Republic, Estonia,

52 U.K.

53 Belgium, Luxembourg.

each country. The nature of what is owned or owed depends on what is a security under the law applicable to that concrete account. Additionally, accounts opened at the level of the CSD are conceived in a different fashion in many jurisdictions than accounts opened in the books of other account providers, as these accounts are sometimes conceived as the "primary record of entitlement"[54].

3.3 The "account-providing" activity

Another important characteristic of "EU cross-border securities clearing and settlement arrangements" is that under MiFID, securities are instruments subject to a certain regulation. In particular, the activity of maintaining securities accounts (*"Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management"*) is a regulated activity subject to an administrative authorisation.

The first consequence is related to the fact that only authorised firms or banks, apart from CSDs, may open and maintain securities accounts. Given this regulatory limitation, patrimonial law tends to recognise as "good property" or "good interest in securities" only what is recorded in the books of this kind of domestic entities. Therefore, when investing through intermediaries creating indirect holdings, it is sometime difficult to assess the nature of what is recorded in the accounts of the account provider that is not part of a domestic system. Clarification is advisable in any case, as the potentially prejudiced is the investor that chooses to invest through its usual account provider, when the latter is not established in the place of the domestic system of reference.

Something similar may be said of the concept of "securities settlement system" for the purposes of the SFD. Only designated systems are allowed to enjoy the benefits of settlement finality, that does not exists in the books of account providers that do not manage designated settlement systems or alike.

3.4 Possible course of action.

The lack of clarity in respect of what are "securities" and "securities accounts", and who may be considered an "account provider" for the purpose of the legal framework of EU cross-border securities clearing and settlement arrangement should be considered a legal barrier by itself.

54 When substitution of paper for book-entries happens, paper does not fully disappear, as there are always Global –jumbo- Certificates, minutes of the General Shareholders Meetings, or Board or Directors, or whatever, where the decision to issue securities is reflected. Therefore, legislators give someone –generally a CSD– the capacity to validly reflect as book entries –with the same legal effect vis á vis the issuer as the paper had before– the exact amount of securities that, according to the (still existing) minutes of the General Shareholders Meetings, or Board or Directors, or Global Certificates, or whatever, have been issued. This "jump", from paper to book entry, will be valid and will have legal effects if the applicable law has endowed the entity holding the book entries (e.g., the CSD or other similar entity) with such capacity. A legislative act is necessary for that. This is why accounts at the level of the CSD are treated differently.

Any measure or policy decision to be taken, should it be the case, in this field, will inevitably find an *ex ante* difficulty of implementation: to who and what will it apply.

Taking into account that "to hold securities" is embedded in the service of "*Safekeeping and administration of financial instruments for the account of clients, including custodianship"* one possible course of action is to consider account provider every intermediary that has a ISD/MiFID licence to operate as such. Any account opened by such an intermediary under that licence and capable to receive a credit of "securities", would be considered a "securities account" for the purposes of our work.

The problem then turns to how to limit the concept of "securities". In order to, on the one hand, not limit any existing activity, and, on the other hand, be consistent to what we have said, the advisable approach would be to require that only the instruments that are financial instruments according to Annex C of MiFID may be eligible to get to be securities for our purposes. Obviously this is not enough by itself, as certain of those financial instruments are mere contracts, and not securities, as said above.

Defining securities is a difficult task, as it has been said. However, there are certain characteristics to all securities: they have an issuer, i.e. someone that decides to offer them; they are thought to be able to be transferred —i.e. to be liquid— in an impersonal way (without knowing who, in turn, will own them) and generally are capable of being admitted to trading in an organised market.

This are the kind of criteria that the national Agencies in charge of assigning the ISIN Code[55] take into account. If the financial instrument does not follow the abovementioned criteria, the ISIN Code is not assigned to it —typically, complex structured financial instruments offered by banks to certain clients—. The ISIN Code is

55 The ISIN Code provides a uniform structure for a universal code that identifies securities. Each country has a designated local agency (National Numbering Agency) responsible for issuing the ISIN code in its territory.

The ISIN code consists of a total of 12 characters as follows:

1. The first two characters are taken up by the alpha-2 country code as issued in accordance with the international standard ISO 3166 of the country were the issuer of securities is legally registered or in which it has legal domicile. In case of depositary receipts such as ADR´s, the country code is that of the organization who issued the receipt instead of the one who issued the underlying security.
2. The next nine characters are taken up by the local number of the security concerned. Where the national number consists of fewer than nine characters, zeros are inserted in front of the number so that the full nine spaces are used. The first 6 positions are filled according and following the same structure used for the attribution of the Issuer Entity's code followed by an alpha-numeric-three characters. The last three characters identifies itself the category of the security such as Common or Preferred Shares, Classes and Commercial Papers.
3. The final character is a check digit computed according to the modulus 10 "Doubled add Doubled" formula.

also assigned to securities which are not going to be listed, provided that they fulfilled the said criteria.

Taking a pragmatic approach, it could be said that for our purposes, any financial instrument that is inside the Annex C and has been assigned an ISIN Code in its country of origin, may be considered a security. Any intermediary that has a licence to custody this instrument should be consider an account provider, and the account where it reflects the balance of securities held for each client should be considered a securities account.

This solution would provide certainty and at the same time would be respectful with current market practice.

> PRECISION: As a consequence, a derivative instrument that is traded in a financial market would be a security for our purposes.

However, this solution does not contemplate accounts opened and maintained by Central Securities Depositaries, which are considered to be by many the "primary root of entitlement". Therefore, this kind of accounts and holdings, for the same kind of securities, should also be included.

NOTE: The definition of what is a "Central Securities Depositary" is the object of the work of the Sub-Group of the CESAME?.

4. The consequences of the current legal environment as regards the relationship between the issuer of the securities and the person bearing the economic risk of the investment (final account holder).

Additionally, national legal systems have a good legal construction regarding the relationship between investors and issuers, but generally this legal construction becomes flawed in indirect holding schemes, as the local system may only recognised the account provider as investor.

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.

Of course, this is a topic with profound implications, as the record of shareholders is also a defensive instrument for the issuers: Issuers are freed from their obligations if they pay to those that are reflected in the appropriate local shareholder register.

HERE: REFERENCE TO THE “RELATIONSHIP WITH THE ISSUER” PART OF THE REPORT.

Ignacio Gómez-Sancha.
Madrid, 29-03-2006.