



EU Legal Certainty Project

Priorities for the Legal expert group

We share the Commission view that the improvement of clearing and settlement systems efficiency largely depends on the regulations governing the securities traded and settled through such systems.

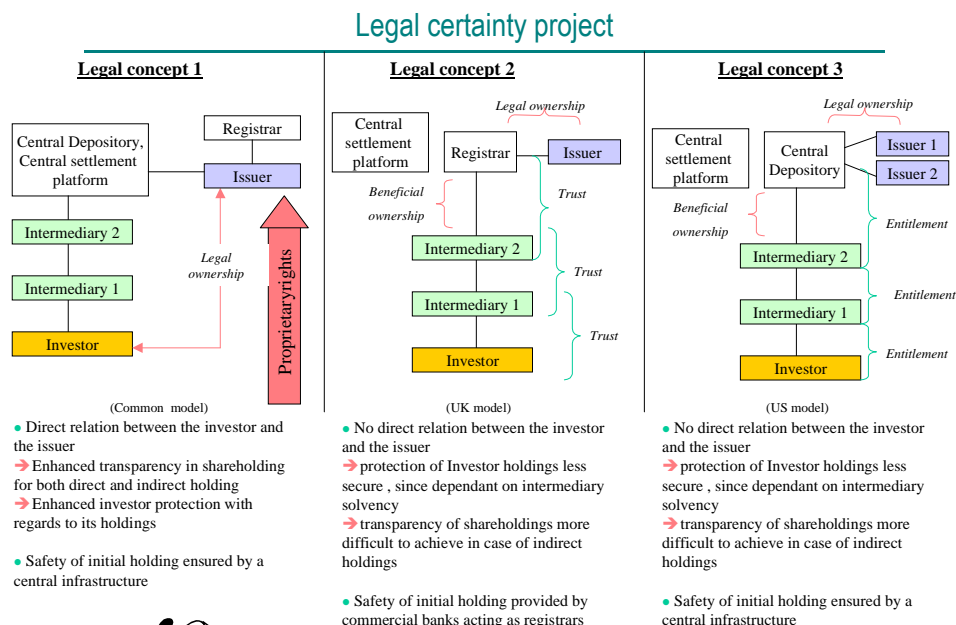
The complexity in finding a unique European set of rules for securities law lies with the multiple branches of law which are involved:

- (i) civil law with respect to the *in rem* or personal right on a security that an investor is granted;
- (ii) corporate law with respect to the characteristics of securities and the regime of corporate events;
- (iii) financial law with respect to the listing, trading, clearing and settlement of securities;
- (iv) tax law with respect to capital gains or income taxation relating to securities.

We believe it is essential:

- First reach a detailed understanding of the current regimes, since different legal structures and market practices have developed in the EU, in the UK and in the US.
- Then, to clarify the perimeter addressed by the Legal Certainty Project. Indeed, the perfect legal soundness would involve considering and tackling simultaneously and consistently all branches of law related with securities. However, this goal may not appear to be easily attainable at EU level. Hence, by endorsing a more pragmatic approach, one could focus on more tangible targets and define a scope of harmonisation which delivers benefits and can be achieved in a reasonable timeframe.

Current legal regimes



Most European countries are based on Legal concept 1

- Securities may be held in a registered or bearer form, which involves or not the compulsory exchange of detailed information concerning the end investor. Bonds are commonly held in bearer form, whereas equities tend to be held in registered form, except for countries such as Germany, France, Italy, Spain, Portugal or Japan where equities are commonly held in bearer form.
- The full regime of securities dematerialisation is developing, without necessarily excluding former rules governing securities : France and Finland were amongst the first to dematerialise securities, 20 years ago, and to enforce the role of CSDs in maintaining a central book of accounts, including the issue account. This example was followed by other European markets, such as Poland and Hungary, and beyond the EU by China and Morocco. A number of other countries, for instance Japan, the USA, the United Kingdom, Belgium and South Africa, are currently considering the introduction of full dematerialisation provisions.
- Most markets operate on the basis of transfer of ownership rules, based on in right rems. These rules allow a direct relationship between the issuer and the investor (i.e. the root of title lies with the CSD and transfer of ownership occurs upon the registration of the securities in the buyer's account). This applies to the newly acceding countries such as Poland, the Czech Republic, Lithuania and Latvia ; or to countries outside the European Union, for instance Japan, China, Ukraine, Egypt, Morocco, Algeria, Tunisia, Jordania, Lebanon. The UK market presents a specific case, since it operates on the basis of legal record, beneficial ownership, nominee and trust rules. The US market also presents a different case, which is based on legal ownership, beneficial ownership, nominee and entitlement rules.
- The EU has implemented a consistent legislative framework to deal with conflict of law issues. It is governed by the *lex rei sitae* principle, such principle being traditionnally applied to all in rem rights. This applies to securities accounts: the Collateral and Settlement Finality Directives are based on the *lex rei sitae* principle, which allows reference to the location of the account within the EU without raising particular issues as to the location of such account. Other countries, such as the US, have enforced conflict of law rules based on a contractual approach between account holders. This rule implies that any conflict of law issues are addressed by the agreement generating these contractual obligations (i.e. *lex contractus*) with potential extra territorial effects in terms of choice of court, choice of jurisdiction and prudential provisions.

Scope of harmonisation at EU level

We share the Commission's view that the seven key items listed in the Communication¹ are the most important to achieve the practical harmonisation of EU securities regulations. We would recommend that a harmonised set of rules is defined, not only by concentrating on general concepts which may prove difficult to translate at Member State level, but rather by paying a particular attention to their effects.

We would like to share our analysis of these key topics and suggest possible views as how to address the resulting issues, with the aim of avoiding divergent interpretations and various applications of the rules in day-to-day financial activities.

¹ Cf. p.26 and 27 of the Communication

1. Nature of investor's rights

The nature of investor's rights usually depends on the physical representation of securities. Solutions may vary from acknowledging a mere personal right to the account holder (in respect to uncertificated securities) to granting the latter with an *in rem* right or ownership right (in respect to certificated securities).

Continental laws have usually maintained the reference to an ownership right as more protective for investors. Without providing for a specific new regime, France is considering that securities in book entry form are owned by account holders, such ownership being strictly protected from any unauthorised use by the account keeper².

Determining a unique regime may appear too ambitious as it would encompass broad areas of civil law (as it refers to the ability to apply the concept of ownership to dematerialised assets), corporate law (as it refers to the rights that are granted to each security holder), financial law (as it directly interferes with the trading and settlement of operations) and tax law (as it affects the way transactions and corporate events are treated).

Financial institutions, as well as investors, are interested in the effective rights granted by book-entries. Fundamentally, any investor seeks:

- the **protection of his rights**, against third parties or bankruptcy of the custodian ;
- the **ability to enforce them** (benefiting from any income or voting rights).

The Commission should therefore seek to adopt common solutions to practical questions dealing with the "*substance in respect of the legal implication for the issuer, the account administrator and the owner of dematerialised securities in a regulated book-entry based system*"³.

As provided in the Giovannini report, the main issues to be addressed consist of:

- the protection of the beneficial owner in case of bankruptcy,
- the protection of the *bona fide* acquirer,
- the regulation of account keepers in order to avoid any accounting shortfall,
- the protection of owners against upper-tier attachments.

As far as the nature of book entries is concerned, we consider that the price of a stock should exclusively depend on its market value and should not be affected by financial factors relating to the custodian. Thus, to avoid devaluation of the right, while taking into account credit factors applicable to the custodian, securities should not be treated as a personal right against the custodian. In this respect, the "*in rem*" analysis seems to be more appropriate to achieve a "protective" goal, since it relies on the autonomy of the securities vis-a-vis the custodian as to its valuation: the securities have a value by themselves, irrespective of the custodian's identity.

² Cf. Art. L. 533-7 of the French monetary and financial Code

³ EFMLG report, p.14

2. Transfer of rights over securities in book entry form and finality

Transfer of rights over securities is mainly a matter of timing and not a question of how it is realised.

Today, on regulated markets, transactions are entered into between members of such markets, acting as principal or as agent. The conclusion of the transaction results from the output of an electronic system, which matches orders and edits in real time the list of binding transactions. On the other hand, on over-the-counter markets, the parties are free to determine how the transaction is entered into. Standard or market master agreements may be used in this respect.

Investors are mostly interested in being able to rely on a unique rule determining the date of transfer of ownership, such rule not being dependent upon the type of securities or the location of their trades. In this respect, three major solutions are currently applied:

- ♦ The date of transfer occurs on trade date: this was the former French solution which had the merit to take immediately into account the existence of the trade and to inform the investor of his obligations. On the other hand, if any problem arises as to the delivery, a corrective measure must be taken, and the entry on the buyer's account needs to be cancelled.
- ♦ The date of transfer occurs on settlement date: this is the rule applied on Anglo-Saxon markets which appears to be the clearest and nevertheless brings uncertainty, since settlement occurs in clearing and settlement systems, outside the control of investors. The transfer is understood not as a physical delivery, but as an accounting entry in the books of the intermediary. Therefore, this solution raises the question of which book entry is supposed to be considered as effecting this delivery.
- ♦ The date of transfer occurs on the date of entry on the account of the investor: since 1993, this solution applies in France for transactions entered into on regulated markets⁴. The entry triggers the transfer of ownership. It is effected on the buyer's account within the custodian book, rather than in the account held by his custodian with higher tier intermediaries or with a CSD. In the same perspective, the EFMLG stressed that the relevant entry should not be limited to the one dealt with by securities settlement systems: "*legal significance should be given to accounts maintained by those who hold securities for others*". One of this effect should be relating to the transfer of ownership.

The question of the date of transfer must not be confused with the very different issue of finality.

Finality was tackled in the Directive n°98/26 of 19 May 1998 and one of the major rules consists of protecting transfers realised after an accurate moment, as determined by the rules of the relevant system (usually once the securities and the cash are credited on the securities accounts held with the CSD and on the cash accounts held with the National Central Bank, acting as cash settlement agent).

The concept of finality seeks to avoid any unexpected unwinding of the transactions, which may eventually lead some of the participants to find, under very tight time constraints, the amount of cash needed to replace the cash not delivered by the defaulting participant. It must be noted in this respect that finality applies to transfer orders, and does not relate to the legal operation which has incurred such transfer order.

⁴ See Art. L. 431-2 of the French monetary and financial code ("*With respect to transactions entered into on a regulated market on financial instruments mentioned in article L. 211-1 I 1°, 2° and 3°, which are held with the issuer or a financial intermediary, the transfer of ownership of such financial instruments result in their entry in the buyer's account under the conditions and at the time determined by rules' market*").

As stated in recital 13 of the Directive 98/26⁵, finality is not linked to the transfer of ownership, but only aims to avoid any cancellation of settlement procedures which may likely cause unexpected and very quick needs of cash, source of eventual defaults and bankruptcy. This element contributes to the efficiency and stability of securities settlement systems and was specifically addressed by the directive of 1998. It should then not be confused with matters related with securities account keeping or transfer of ownership, which are more likely to rely on custodians.

Finality is a global issue related to the general good functioning of the financial system, whereas the transfer of ownership is focused on bilateral transactions and on the direct interest of sellers and buyers in a transaction. This approach is usually illustrated by the fact that ownership or beneficial interest results from entries in the accounts held by custodians and not by entries in the books of the CSD.

Finally, it may be noted that the directive on Collateral Arrangements⁶ has pragmatically provided that, in order to limit administrative burdens, perfection requirement of financial arrangements shall be limited to entering into possession or under the control of the collateral taker. Such possession will very much likely be "represented" in the accounts of the custodian of the collateral taker (or collateral giver in case of a pledge), where beneficial interests are represented, and not in the accounts of the CSD, where assets are globally held in omnibus accounts in the name of custodians acting on behalf of their clients.

3. The treatment of upper-tier attachment⁷

The treatment of upper-tier attachment is a rather complex question, since it mainly arises in cross-border transactions. It is prohibited in almost any national legal securities regime. However, such issue is not easily addressed in an international context, where (global) custodians open omnibus accounts with other (local) custodians. In this context, the local custodian has a unique contractual relationship with his customer (i.e. the global custodian) and usually, in order to cover his own fees, requests from the latter a pledge on all the assets held in the account, even if these assets are held on behalf of the account holder's clients. In addition, it is not always possible for the local custodian to refuse to perform any attachment requested by his client's creditors where the assets are credited in an account in the name of the client-debtor.

In any case, it is important and necessary, in order to assess the global stability and safety of international custody of indirectly held securities, that upper-tier attachment should be prohibited. The Unidroit project of Convention on substantive rules on indirectly held securities expresses the same concern⁸ and should be duly considered.

The solution needs a clear principle according to which financial instruments held on behalf of customers should not be considered as part of custodian's assets, even if these assets are credited in an account in the name of such custodian.

This issue seems to be correctly addressed by strict and enforceable rules of assets segregation by custodians. It is market practice for a custodian to hold assets with an upper-tier CSD or custodian in segregated accounts, by separating his own assets from the client assets. In this respect, assets held on behalf of third parties should be held in a different account than those held for the custodian own account.

⁵ Recital n°13: "nothing in this Directive should prevent a participant or a third party from exercising any right resulting from the underlying transaction which they may have in law to recovery or restitution in respect to such transfer order which has entered a system, e.g. in case of fraud or technical error, as long as this leads neither to the unwinding of netting nor the revocation of the transfer order in the system"

⁶ N°2002/47 of 6 June 2002

⁷ This term designates the possibility offered to a creditor to attach assets held in accounts not on behalf of the account holder, but on behalf of third parties (usually clients of the account holder).

⁸ See Art. 4 (3) and the explanatory note below

4. Investor protection from insolvency of the intermediary

This question is usually one of the first to be addressed by national regulations.

In Continental jurisdictions, the rule always provides a protection for account holders by granting the latter a direct right, as far as possible, to have their financial instruments transferred with another custodian. For instance, in France, a specific rule has been set forth in article L. 431-6 of the French monetary and financial code. This article states that in case of the opening of bankruptcy proceedings against a custodian, any account holder may ask for the transfer of the securities, provided that the same amount of similar securities are credited in such custodian's account opened in the books of a CSD or another custodian. If it is not the case, the securities are proportionally apportioned among the relevant account holders.

This solution is the most common rule applied in European countries and may be adopted at EU level without creating excessive problems. The Unidroit project suggests the same principles⁹.

5 Acquisition of rights over securities by third parties of good faith

It is a quite commonly adopted rule that one cannot transfer a more extensive right than he enjoys himself. With respect to ownership, a person who is not the real owner of a particular asset is not in a position to validly transfer to a third party the ownership of such asset.

In order to provide a minimum of legal certainty, this rule was usually amended with respect to tangible assets¹⁰ In the case of dematerialised securities, the need for legal certainty requires the implementation of a common rule in order to protect the *bona fide* acquirer.

In order to acknowledge to the transferee a clear and valid title, the protection could be granted to any transferee if the latter were not aware of any challenging action at the time he received in his account the securities. In this respect, the acquirer should be in a position to clearly ascertain whether the conditions upon which he receives securities are, from his knowledge, clear or challengeable.

6 Transfers of rights deriving from corporate actions

Corporate events raise difficulties as to how they should be dealt with, when occurring between the trade date and the settlement date.

If they occur before the trade date, the seller is the only beneficiary (the securities are deemed traded "ex"), whereas if they occur after the settlement date, the buyer is supposed to be the beneficiary (the securities are deemed traded "cum").

Between trade date and settlement date, the issue raised is whether the corporate actions (essentially dividend or interest rights, subscription rights...) are granted to the seller or the buyer.

Under French law, this question is solved by market rules (i.e. Euronext Paris SA) since it is linked to listing issues, and in particular when listing systems stop integrating in the listing quote,

⁹ See Art. 6 and 7 of Unidroit draft of convention

¹⁰ As provided in article 2279 of the French civil code: "The fact to acquire in good faith an asset and to be put in possession of the same, is sufficient to grant the acquirer with the valid and unchallengeable right over the transfer of asset."

the price of the corporate event¹¹. In practice, Euronext has implemented different rules for equity and bond markets.

- On the equity markets (mainly concentrated on regulated markets), corporate events which occur after trade date are in favour of the seller, since the transfer of ownership is deemed to occur on trade date.
- On the bond markets, which are mainly driven by OTC transactions, interests are calculated for the benefit of the seller until settlement date, since the market practice stipulates that the transfer of ownership occurs on settlement date.

However, the settlement date is also important, since the electronic treatment of such events relies on the custody positions of investors: investors who have the securities entered in their accounts on the date of the corporate event are likely to receive the rights deriving from such event through the market infrastructure systems. Therefore, harmonised substantive rules should be accompanied with harmonised market infrastructure systems in order to achieve an efficient harmonisation with respect to corporate events.

Specific attention should be paid to voting rights which are more dependent than other corporate events on corporate law. In this respect, any harmonisation in this matter should follow, as a first step, a study aimed at evidencing the common corporate rules that may be defined out of current national regulations.

7 Choice of securities location

The choice of securities location involves two different issues.

- The first relates to the location of securities, as to the law applicable and to the rights applicable to them. This aspect of the question refers to the question raised by the Hague Convention as to whether the EU *lex rei sitae* rule may be waived in favour of the *lex contractus* rule, without any "incidental" effect.
- The second issue relates the location of securities at the highest level, i.e. their deposit with a CSD. As a principle, any issuer should be in a position to select the CSD irrespective of the place of incorporation of the issuer or of any external factor to the issuer, such as legal or issuance procedure considerations. Even if no regulatory consideration should impose the location, for economic reasons, such choice is usually driven by the choice of the market which provides the issuer with greater liquidity.

¹¹ Once a security is traded "ex" and not "cum", listing electronic systems automatically reduce the offered prices of the amount of the relevant corporate event