



## Memorandum

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To: DG Internal Market

From: Euroclear

Date: 22 September 2004

### **Preparatory information regarding European Legal Harmonisation**

This note describes Euroclear's recommendations with regard to the legal barriers that should be addressed as priority items by the Legal Working Group that the Commission intends to set up as a follow-up of its Communication on Clearing and Settlement in the European Union dated April 28, 2004. A summary of the main points made is contained in an Annex on page 13. The note is sent in response to the request, contained in the minutes of the CESAME Group held on 15 July 2004, for the market to provide input on these issues.

In particular, we identify issues that complicate and prevent the full implementation of major initiatives that the market is undertaking on platform consolidation and harmonisation. We believe that addressing these issues will result in tangible cost savings in the near to medium term, while more complex and long-term reforms (such as achieving common treatment of interests in securities) remain ongoing.

It is still fairly early in the European harmonisation process; there will undoubtedly be other issues which come to light as the work progresses, as well as issues that other market participants and authorities will be in a better position to identify.

We look forward to discussing these issues with the Commission directly. Any questions on this note should be addressed to Diego Devos ([devos\\_diego@euroclear.com](mailto:devos_diego@euroclear.com)) on +32 (0)2 224 1444.



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## I BACKGROUND

Ideally, common legal frameworks should be put in place across Europe to support fully cross-border issuance and settlement. Such common frameworks would need to include:

- Common conflicts of laws rules
- Common or mutual recognition rules for securities issuance
- Common tax treatments and processing rules
- Common interests in securities rules (as supported in the second Giovannini report published in 2003)
- Regulatory passport for CSDs/settlement service providers
- Common company laws in certain key areas

However, achieving all of the above will be complex to implement and will probably take many years. Addressing more focused legal issues in the meantime could have a more immediate, tangible effect on reduction of cross-border risks and costs for the market. We refer the Commission to Euroclear's response to the Commission's recent Communication on clearing and settlement which contains further details on the costs of cross-border clearing and settlement.

Euroclear believes that these costs can be most effectively addressed by platform consolidation and harmonisation. However, certain **legal and regulatory barriers** will reduce the extent to which the market can achieve these two goals. These generally fall into the following categories:

- local requirements that would hamper full and simplified settlement platform consolidation;
- requirements for local presence;
- laws and regulations that do not recognise multi-intermediary settlement chains;
- barriers to multi-intermediary use of collateral;
- restrictive market rules or practices that are imbedded in local law and regulation



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## **2 PROPOSED PRIORITIES FOR ADDRESSING LEGAL AND REGULATORY BARRIERS**

Euroclear has identified<sup>1</sup> a number of laws and regulations that fall into the above five categories. The order in which the priorities are presented reflects our assessment of the importance, from a securities industry's perspective, of the legal/regulatory barriers; however, it is our belief that all five should be undertaken as parallel priorities. In addition, we support the EU harmonisation of the treatment of interests in securities held with an intermediary ("Legal Certainty Project") as suggested by the Commission in its Communication on Clearing and Settlement.

- 1. No uniform conflict of law rules-The lack of uniform conflict of law rules creates legal risks in cross-border transactions and interferes with further consolidation by market participants and settlement systems.*

Settlement participants need sufficient certainty that a court will uphold the law chosen by the parties to govern a securities transaction involving multiple jurisdictions. If a court will not uphold the parties' choice of applicable law, the parties may lose their rights to the relevant assets.

In order to avoid this legal risk, market participants need to have clear rules that will tell them when a court will apply the law that they have chosen or another law (so-called "conflict of law rules"). However, in many jurisdictions (including key EU jurisdictions), there is no specific law, regulation or jurisprudence that identifies the factors that a court will consider in determining the applicable law. This lack of certainty means greater exposure and therefore greater cost of collateral in cross-border transactions; some lenders may not accept certain securities as collateral because they cannot identify the likely applicable law.

Legal priority 1 should therefore, achieve the full and rapid implementation<sup>2</sup> of the Hague convention on the Law applicable to certain rights in respect of securities held with an intermediary, dated December 13, 2002, which clearly defines which law shall govern securities entitlements and proprietary aspects (including collateral rights) on book-entry securities held through intermediaries. Equally strong support

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<sup>1</sup> See also the Euroclear Consultation paper entitled "Harmonisation Fundamentals" of June 30, 2004, especially section 8 and Appendix 1 listing the preliminary legal and regulatory barriers identified in the course of the implementation of Euroclear Business Model and related harmonisation areas.

<sup>2</sup> Including by way of appropriate modifications, where necessary, of the existing EU legal framework such as the Settlement Finality Directive, The Directive on the Reorganization and Winding-up of credit institutions and the Collateral Directive.



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should be given to the Hague implementation outside the EU because of the large number of cross-border securities transactions with non-EU counterparts.

**Recommended Priority 1: Rapid implementation of the Hague convention in the EU, and strong support for rapid implementation elsewhere.**

*2. Requirements for local presence or local regulatory status will reduce the value of market harmonisation efforts*

Several EU jurisdictions retain “national-oriented protection” rules relating to the physical location of activities such as:

- requirements to open or maintain a local office in order to be entitled to act as withholding agent, act as general clearing member, or to act as a recognised CSD or otherwise provide settlement and custody services to local residents ;
- requirements to locate register ( for registered securities) or accounts physically in the country of the issuer;
- requirements (in law or practice) that restricts local membership in CSD to local intermediaries only;

The above requirements directly contribute to the fragmentation of markets and impose additional costs by reducing the value of other market harmonisation efforts. Some examples:

- Where the presence of a local office is required, there are additional administrative costs, separate accounting, property costs, local staff requirements, and local regulatory compliance costs, as well as potentially also separate capital costs.
- Local requirements that the register or account be physically located in a particular jurisdiction ( as in the UK) prevents full IT consolidation for registrars operating cross-border; in countries where the settlement system acts as registrar for dematerialised securities, this again reduces the synergies that can be achieved from full platform consolidation by requiring duplication of processing, records and/or communication networks in those countries. Such duplication also adds unnecessary complexity to IT arrangements that are partially centralised (by requiring that processing that is located in different countries in order to meet regulatory requirements be interlinked with

those processes that can occur centrally); this can effect the scalability and cost of upgrading systems in the future as well.

- Notwithstanding the operation of the Investment Services Directive and the Second Banking Directive, some local regulatory practices continue to have the effect of requiring a local presence and/or special local regulatory status in order to access directly the local settlement system or to provide some custody services. This can be imposed through laws or regulations<sup>3</sup>, but also through disproportionately heavy requirements to be fulfilled obliging de facto a non-resident firm to act in the local market through a local intermediary. If such restrictions are maintained, the value of harmonisation of market practices will be reduced as many firms will continue to find it necessary to act through a local agent rather than put complex structures in place to meet local regulatory requirements.

Some of the above laws and practices may be difficult to eliminate altogether; however, it should be explored whether limited modifications of the relevant laws/regulations could deliver significant benefits even without full removal of the relevant physical presence requirements (in particular with respect to register requirements) which may continue to apply for example as a matter of general company legislation.

**Recommended Priority 2: Removal or modification of requirements that explicitly or effectively require physical presence of any settlement related activity in an EU jurisdiction, including:**

- **modification of requirements to physically locate a register in a jurisdiction;**
- **elimination of local rules that give different rights to domestic vs. other EU intermediaries (e.g., by granting special status to certain categories of local intermediaries);**
- **elimination of any mandatory requirement for the appointment of a local intermediary to act as a**

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<sup>3</sup> For example, in France, remote members acting as "intermédiaire inscrit" with the local CSD for holding nominee positions on behalf of non-French clients may not be allowed, in a certain interpretation of French law provisions, to carry out for such clients some services like the issuance of BRNs ("bordereaux de références nominatives") (to update the issuer's records) since such services are restricted to intermediaries (whether French or foreign acting in remote access under European passport) acting as "teneurs de comptes". The situation based on French law and regulations is however unclear and market practice often does not reflect a strict interpretation of the law. This should be clarified.



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**withholding agent, clearing member , CSD or intermediary for local residents; and**

- **elimination or modification of laws, regulations and regulatory practices that effectively result in access restrictions to membership of local settlement systems, at least in favour of all financial institutions.**

3. *Local company laws which do not take into account that there are multiple layers of intermediaries involved in cross-border settlement will reduce the value of market harmonisation efforts*

There continue to be local requirements that do not recognise or accommodate the fact that cross-border settlement normally involves several layers of intermediaries. Such requirements reduce the extent to which cross-border holding and corporate actions can be efficiently processed, thus reducing the value of other market harmonisation efforts. Examples of this are laws and regulations that do not recognise the concept of nominee holdings (which could lead to prohibit voting through nominee), or otherwise prevent or penalise the holding of securities in fungible form.

For example, some countries have requirements to maintain individual records or accounts per owner which increase processing costs cross-border. Either such securities must be held directly in individual accounts, or each intermediary must implement costly, time consuming and error prone internal procedures in order to comply with these local rules. Such requirements can be explicit, or can be a result of reporting or proxy voting requirements. In such cases, the desire of issuers for information about beneficial owners has been - - or is in danger of being - - implemented in a way that adds unnecessary barriers and costs to cross-border holding.

As an illustration of the above, in certain countries, (e.g. Greece and Portugal) the concept of a split between legal or registered ownership and beneficial ownership of securities is not recognised in law. A person holding securities as a nominee on behalf of others (such as clients and beneficial owners) is not recognised and, thus, the entity registered will be regarded as the real owner of the securities and all other entities (clients and their customers or other custodians) are considered as third parties. As a result, in these countries, the registered shareholder legally entitled to vote is the registered intermediary or its nominee company. The real beneficial owner of the securities holding through the intermediary does not have a right to vote (and/or partial voting is impossible).



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Nevertheless, numerous mechanisms have developed by market practice to allow voting by the beneficial owners in these countries (use of interim accounts per owner also used for holdings in the Scandinavian jurisdictions, etc). However, there are limitations and complexities related to the absence of the nominee structure that impede the exercise of these voting rights and the cross—border provision of custody services.

Some other countries do not treat assets held by local and non-local residents equally for purposes of fungible or nominee holdings. In France, for example, the structure of holdings is different for securities in registered form held on behalf of non-residents or for French residents. This adds complexity and cost for non-residents, due to need to ascertain national identity of holders down the chain, and need for different procedures for local and non-residents.

**Recommended Priority 3: Removal or modification of requirements that do not recognise the multi-layer holding structure that is the norm in cross-border activities, including:**

- **recognition throughout the EU of the pooled holding of registered assets through a nominee structure (and the different nature of legal and beneficial ownership) in order to keep registered securities on a fungible basis at local level and protection of the rights of the nominee;**
- **elimination or modification of requirements that directly or effectively require the maintenance of individual records or accounts per beneficial owner;**
- **equalisation of rights of resident and non-resident market participants under local ownership regimes.**

4. *Local or policy rules that prevent efficient cross-border use of collateral will reduce the value of market harmonisation efforts*

Some local rules continue to prevent intermediaries from using client assets to support settlement on behalf of client efficiently (for example, custodians in some countries may not place assets with a settlement system or intermediary in another EU country - - notwithstanding proper authorisation of such system or intermediary in its home country - - or are prevented from using client collateral to secure settlement in such non-resident system or intermediary). Similarly, the Settlement Finality



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Directive (SFD) has not been uniformly implemented to extend its protection to transactions between participants of the relevant settlement system – in such countries, only collateral transactions with the system operator and NCBs are protected. Some countries have however adopted protections that go beyond the SFD which increase certainty of settlement cross-border and therefore reduce costs, such as uniform protection from attachment of assets held in a relevant system.

ESCB Standards for the use of securities settlement systems for monetary policy transactions and ECB policy for the cross-border use of collateral also prevent national central banks from directly holding securities as collateral in CSDs outside their home country (on a remote access basis), unless under specific limited exceptions with ECB approval. In practice this leads to inefficient and costly fragmentation of collateral portfolios of financial intermediaries.

**Recommended Priority 4: Eliminate impediments to free use of collateral cross-border and increase protections for such collateral use in settlement systems covered by the SFD, including e.g.:**

- **introduce in the EU a non waivable "purchase lien" allowing an intermediary to have transfer of ownership for security purposes on unpaid securities purchased on behalf of clients allowing it to re-use/rehypothecate the securities in favour of another EU intermediary or settlement system**
- **Reform of Settlement Finality Directive to uniformly extend the protection to transactions between participants in settlement systems, to prohibit attachment proceedings within a settlement system and to otherwise support the robustness of cross-border settlement**

**5. Local rules or practices that are imbedded in local law or regulation (or regulatory practice) will prevent effective harmonisation of market rules**

Finally, overall harmonisation efforts of market rules will need to be supported through the removal of various laws and regulations which have been structured to reflect such market practices and rules. For example, differences in the moment where ownership transfers result in different procedures to be followed for each country or type of instrument. In a same country, legal transfer of ownership may be treated as taking place on trade date ( this is the case in France for stock exchange



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transactions) while other types of transactions may entail transfer of ownership only on settlement date ; the latter is the common rule in most EU countries. This variety of regimes has a substantial cost impact for market claims and tax processing, as every difference results in a different procedure. This could also generate legal risks to the extent that insolvency of a counterparty occurring between transfer of ownership on trade date according to home stock exchange (SE) rules and settlement date in a foreign settlement system where the settlement of the same SE transaction actually takes place, may lead to questions about ownership rights.

**Recommended Priority 5: Eliminate impediments to harmonisation of market practices, including:**

- **harmonisation of transfer of ownership rules for purposes of (a) trading procedures, (b) fiscal procedures, and (c) settlement procedures**
- **Harmonisation of proxy voting rules**
- **Harmonisation of the registrar practices for registered securities**

**6.** *Harmonisation at EU level of the treatment of interests in securities held with an intermediary (« Legal Certainty Project »)*

We welcome the Commission's views as expressed in the Communication about the need for a sound, reliable and predictable legal framework in the EU in respect of indirectly held securities.

We believe that only a few jurisdictions offer today an adequate legal framework for holding and transferring book-entry securities in a cross-border environment. For example, most jurisdictions may provide investors with a sound ownership regime on domestic securities held directly with the domestic CSD or with domestic intermediaries. But only a few legal regimes have organized specific rules for holding and pledging **domestically**, under domestic law, securities primarily issued and deposited abroad through an account of the relevant intermediary with the foreign "issuer CSD" or with a local custodian. This generally supposes that the interest in such foreign securities is treated as a specific entitlement governed by the national law of the relevant intermediary (



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under the Hague Convention rules) distinct from any direct traceable entitlement to the underlying foreign securities which remains governed by local ownership law. This would certainly deserve specific focus at EU level to ensure that all EU jurisdictions would adopt consistent harmonised regimes for such cross-border treatment of interests in securities.

By the same token, as already mentioned in the Commission's Communication, it will also be crucial to further enhance the legal certainty in intermediated holdings of securities by addressing at least the following issues<sup>4</sup>:

- Clear legal protection of account holders enforceable in case of insolvency of the relevant intermediary;
- Determination of the rights of the account holder with respect to the securities credited to its account, in particular vis-à-vis the issuer in terms of economical ( cash payments, redemption, etc) and non-economical rights ( voting rights, etc);
- Protection against misappropriation;
- Protection against upper-tier attachment proceedings at the level of the intermediaries of the relevant intermediary;
- Protection of good faith purchasers;
- Correction of possible inconsistencies which would be identified between the various EU legal instruments adopted on book-entry securities matters ( in particular, the Directives on Settlement Finality , Collateral and Winding-up of credit institutions; Insolvency Regulation) and their domestic implementation;

**Recommended priority 6: Harmonisation at EU level of the treatment of interests in securities held with an intermediary (« Legal Certainty Project ») in order to achieve:**

- **Consistent approach in the national treatment of foreign securities through the recognition of a specific entitlement, distinct from any direct traceable right in the underlying foreign securities;**
- **Protection of account holder against the insolvency of its intermediary and clarification of its rights against the issuer;**

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<sup>4</sup> We understand that Unidroit is currently working on a specific draft Convention ( see the "Draft Convention on substantive rules regarding securities held with an intermediary-April 2004 version") which is aiming at addressing most of the issues we list in the main text. But this Draft Convention is not limited to the EU and will have to take into account legal regimes of other countries in the world which did not reach a similar level of harmonisation in securities matters as the EU/EEA countries. Secondly, we have some fundamental concerns with current draft Convention which interferes with regulatory sphere and basic industry practices.



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- **Protection of the relevant intermediary against upper –tier attachment risk; protection of good-faith purchaser;**
- **Elimination of any inconsistencies between EU legal instruments (SFD, Collateral and Winding-UP directives; Insolvency Regulation) dealing with book-entry securities.**



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## **ANNEX SUMMARY OF PROPOSED LEGAL AND REGULATORY PRIORITIES**

In Euroclear's views, the following priorities should be undertaken to reduce risks and associated costs of cross-border settlement as much as possible, even in the absence of common securities and tax laws.

Recommended Priority 1: Rapid implementation of the Hague convention in the EU, and strong support for rapid implementation elsewhere.

Recommended Priority 2: Removal or modification of requirements that explicitly or effectively require physical presence of any settlement related activity in an EU jurisdiction, including:

- modification of requirements to physically locate a register in a jurisdiction;
- elimination of local rules that give different rights to domestic vs. other EU intermediaries (e.g., by granting special status to certain categories of local intermediaries);
- elimination of any mandatory requirement for the appointment of a local intermediary to act as a withholding agent, clearing member, CSD or intermediary for local residents; and
- elimination or modification of laws, regulations and regulatory practices that effectively result in access restrictions to membership of local settlement systems, at least in favour of all financial institutions.

Recommended Priority 3: Removal or modification of requirements that do not recognise the multi-layer holding structure that is the norm in cross-border activity, including:

- recognition in the EU of the pooled holding of registered assets through a nominee structure (and the different nature of legal and beneficial ownership) in order to keep registered securities on a fungible basis at local level and protection of the rights of the nominee
- elimination or modification of requirements that directly or effectively require the maintenance of individual records or accounts per beneficial owner



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- equalisation of rights of resident and non-resident market participants under local ownership regimes

Recommended Priority 4: Eliminate impediments to free use of collateral cross-border and increase protections for such collateral use in settlement systems covered by the SFD, including e.g.:

- introduce in the EU a non waivable "purchase lien" allowing an intermediary to have transfer of ownership for security purposes on unpaid securities purchased on behalf of clients allowing it to re-use/rehypotheate the securities in favour of another EU intermediary or settlement system
- Reform of Settlement Finality Directive to uniformly extend the protection to transactions between participants in settlement systems, to prohibit attachment proceedings within a settlement system and to otherwise support the robustness of cross-border settlement

Recommended Priority 5: Elimination of impediments to harmonisation of market practices, including:

- harmonisation of transfer of ownership rules for purposes of (a) trading procedures, (b) fiscal procedures, and (c) settlement procedures
- Harmonisation of proxy voting rules
- Harmonisation of the registrar practices for registered securities

Recommended priority 6: Harmonisation at EU level of the treatment of interests in securities held with an intermediary (« Legal Certainty Project ») in order to achieve:

- Consistent approach in the national treatment of foreign securities through the recognition of a specific entitlement, distinct from any direct traceable right in the underlying foreign securities
- Protection of account holder against the insolvency of its intermediary and clarification of its rights against the issuer;
- Protection of the relevant intermediary against upper -tier attachment risk; protection of good-faith purchaser



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- Elimination of any inconsistencies between EU legal instruments ( SFD, Collateral and Winding-Up directives; Insolvency Regulation) dealing with book-entry securities.