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Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Financial markets infrastructure

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**Subject: EU Clearing and Settlement - Legal Certainty Group
Synthesis Report of the meeting held on 31st January 2005**

This was the first meeting of the Commission's 'Legal Certainty Group'. Minutes, recording the decisions reached at the meeting, have been prepared separately. The purpose of this Synthesis Report is to capture the discussion that was held at the meeting together with relevant information that formed the background to that discussion

1. CHAIRMAN'S INTRODUCTION

The Chairman, Pierre Delsaux, Head of Unit for Company law, Corporate Governance and Financial Crime in the Commission's Directorate for Free movement of capital, company law and corporate governance, welcomed the Group's members and highlighted the importance of the Group's work.

It was recalled that legal issues had been identified as one of the fundamental barriers to making cross-border clearing and settlement as efficient, safe and cost-effective as it is at national level. The establishment of this Legal Certainty Group would help to validate and identify ways to overcome this kind of barrier, and thus contribute to the opening up of the EU clearing and settlement environment. The integration of European securities clearing and settlement systems requires coordinated action by private and public sector bodies. Removal of legal barriers implies a public sector action, and the Legal Certainty Group should be seen as a key step to achieving this.

The Commission Communication on Clearing and Settlement, adopted in April 2004, had proposed the setting up of group of legal experts, as a specific exercise intended to address problems of legal uncertainty identified in the context of considering the way forward for clearing and settlement in the European Union. The suggestion made in the Communication was for a group composed of experts from academia, public authorities and practicing lawyers. A core secretariat would provide necessary impetus for the project; and the project was not expected to be short-term, given the complexity of the subject and its intricate connection with national property and company law.

The Legal Certainty Group had been duly established in fulfilment of and conformity with that proposal.

A strong desire shared by the Commission and by industry, including as voiced in CESAME, to see legal barriers to efficient EU cross-border clearing and settlement addressed quickly required that this first meeting be arranged as soon as possible; in

consequence a few members had not been able to clear their schedules in time, and were not present. A list of those present appears at the end of this synthesis report.

The driving force in the composition of the group had been the desire to capture expertise, rather than representation. The institutions from which the Group's members are drawn would be mentioned in the list of members solely in order to indicate the wide range of relevant expertise with which the Group had been constituted.

The Group has 36 members. Conformably with the Commission Communication on Clearing and Settlement, adopted in April 2004, the group is constituted of members being academics, practitioners and public officials. Of the practitioners, some are from law firms, some from infrastructure bodies (CSDs, ICSDs, and exchanges) and some from banks. There is at least one person expert in the main legal system of each member state, which is viewed as especially important given the sensitivity of this work and the fact that it will touch upon national substantive laws. The composition of the Group has been carefully designed to balance both national jurisdictions and stakeholders. The group has also been set up to include experts covering a very wide range of legal areas, including laws concerning clearing and settlement of securities, deposits and custody, financial market transactions, collateral, insolvency and rights of shareholders. The group composition is not fixed once and for all. The composition of the Group might evolve along with the different subjects to be tackled.

The Chairman introduced those assisting in the development of the Group's work. The Group is managed with the Commission's Financial Markets Infrastructure Unit, headed by Mario Nava. Those most involved in the Secretariat function are: Martin Thomas, the Group's Secretary (a national expert on secondment from the Bank of England), Klaus Löber (an international expert on secondment from the ECB) and Konstantinos Tomaras, a Commission official.

Other staff from Commission's Financial Markets Infrastructure Unit, from the Commission's Company Law, Corporate Governance and Financial Crime Unit, and Financial Markets and Financial Intermediaries Unit (in the Economic and Financial Affairs Directorate-General) were also present.

The agenda¹ was approved.

2. CONTEXT OF LEGAL CERTAINTY GROUP

The Legal Certainty Group has been established as part of a drive to ensure that the financial sector is able to reap the benefits of the single market.

Some overarching remarks appropriate to an inaugural meeting were given by Director-General Alexander Schaub. He said that the legal issues to be discussed and analysed were of deep importance to the integration of EU securities markets, and EU clearing and settlement systems in particular. He noted the high level of expertise collected in the Group, being composed of experts from academia, public authorities and practicing lawyers. This was a good mix for the development of the law. He said that cross-border clearing and settlement is a specialism even within the community of lawyers familiar

¹ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm

with financial markets transactions. As the Group must produce advice that will be accessible and understandable to all, great care would be needed to expose the topic to those not yet involved in its detail.

He emphasised the value of consultation, especially for technical legal initiatives. They are usually not only 'technical': they affect wider interests than only those with direct commercial or professional experience. The views of normal unsophisticated investors, the underlying owners of securities, must be fully ventilated in the debates. And other views may if appropriate be inserted into the process.

He thanked members for accepting his invitation to join the Group and for their public service in shouldering the burden of its work.

2.1. Liaison with CESAME

The Legal Certainty Group is a sister group to CESAME and to the Fiscal Compliance Experts Working Group, all three of which have been established in accordance with the proposals made by the Commission in its Communication on Clearing and Settlement, adopted in April 2004. It is notable that the responses made to the Communication were unanimously in favour of the establishment of the Legal Certainty Group and of the project to address legal barriers to efficient EU cross-border clearing and settlement of which it forms the heart.

CESAME (detailed and full information about which is available on the Commission's website²) started its work in July 2004. It will continue until at least the end of 2005, or longer as necessary to obtain the input of stakeholders to finalise the Impact Assessment the Commission is currently conducting. The work of CESAME might lead to the Commission making a proposal for a framework directive about the post-trade environment. The Legal Certainty Group, by contrast, has a different and potentially wider scope. Accordingly, the expected time-span of the Group is longer than that of CESAME, and may be some two years or more.

The work of CESAME currently includes investigating how to establish a common usage of technical terminology, through a 'Definitions Sub-Group', in order to marshal the debate.

It is intended that the Legal Certainty Group, CESAME and the Fiscal Compliance Experts Working Group will work in parallel, each closely following and where appropriate feeding into the work of the others. This liaison will be achieved through updates of each at the meetings of the other; through flow of information, via website; and through flow of information, via secretariats.

2.2. Other relevant Commission work in progress

The Commission currently has a number of activities relating to the infrastructure of the EU financial markets and to the legal framework and issues that arise in that context. All

² http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en.htm

of this work is strongly informed by the Commission's drive to proceed in conformity with the principle of Better Regulation, in this context especially the understanding that legislative initiatives must maximise efficiency and minimize unnecessarily intrusive rules.

The Commission is preparing a report about the state of implementation of the Settlement Finality Directive (98/26/EC), on the basis of a questionnaire the Commission has sent to Member States. Depending on the responses received, this report may contain proposals for amendments to that directive. It is scheduled to be released before the end of 2005.

In mid-2005 a similar process will start related to the state of implementation of the Financial Collateral Directive (2002/47/EC).

The Commission Action Plan on modernising company law and enhancing corporate governance in the European Union recognised that improving the rights of shareholders of companies across the Member States was a priority. This would include the right to ask questions, the right to table resolutions, the right to vote in absentia and the right to participate in general meetings via electronic means. These facilities should be offered to shareholders across the EU. Specific problems relating to cross-border voting should therefore be solved. Accordingly a directive about shareholders' rights is planned: it will also affect securities markets and their infrastructural context, in particular as regards the read-across to the identified legal barrier concerning the processing of corporate actions, as well as to the general strand of work aimed at establishing appropriate rights for holders of securities in a cross-border single market.

3. REVIEW OF SCOPE OF MANDATE

The Group's mandate essentially involves undertaking in-depth analysis of the issues raised in the Commission's Communication on Clearing and Settlement, adopted in April 2004, proposing solutions to such problems of legal uncertainty as have been confirmed by the analysis, and informal assistance through the provision, on request, of advice to the Commission on specific technical issues.

The Legal Certainty Group is not a policy group. The mandate requires the Group to avoid policy debates: the group will seek further instructions on all such questions, from the Commission, which will in turn take into account advice where relevant of CESAME;

It was noted that the issues to be addressed have a potential significance wider than that of the arena of clearing and settlement, in that rules on the rights to and transfer of securities touch on many other aspects of the EU single market in financial services. Of course, the work was aimed at issues wider than those related to the development of any directive about clearing and settlement. Nonetheless, the work of the Group should address such issues from the clearing and settlement perspective: the Commission's policy development in that area was the genesis of the Group, and that fact should inform the Group's work.

The level of enquiry was discussed. Was the work of the Group aimed at national, or at cross-border, clearing and settlement legal problems? It was felt that the bulk of the work

would be in the latter. The efficacy of national legal regimes was not under consideration: rather, it was the problem of how they interlink.

It was noted that the issues to be addressed have sometimes seemed in the past to be intractable. Reference to the challenges inherent in harmonizing rules on the rights to and transfer of securities in the EU has been made in previous initiatives, such as the Schlosser report and the Virgos-Schmidt report. One early hurdle will be to settle upon a common vocabulary for the conduct of the work: even expressions (*in rem*, for example) that are used in most if not all EU legal regimes turn out on analysis to be used with different meanings. Indeed, the necessity of establishing a common usage of technical terminology was a constant theme of the meeting.

It was asked whether the Hague Convention on the Law Applicable to Indirectly Held Securities was to form part of the Group's work. It was not. The approach of the Group would be to treat private international law as a matter separate from substantive law. The Legal Certainty Group would be 'conflicts-neutral', that is to say it would consider issues surrounding rules on the rights to and transfer of securities in the EU without reference to or assumption of any particular rule of private international law.

There was a discussion about the scope of enquiry relating to cash, derivatives, fixed-income *vs* equity securities, and 'bearer' securities.

Cash: some felt that it should be included, as in market practice collateral arrangements often include cash, substantially or incidentally, and it would be impractical to have different rules for different elements within a collateral arrangement. Nor can cash necessarily be treated as subject to different rules for establishing ownership: in Italy, for example, cash and securities can under some circumstances both be ring-fenced from the insolvency of the account-maintaining intermediary. The role of cash is also pivotal to the DvP aspects of settlement, thus further justifying its inclusion. Overall, the Group decided to start its work with a focus on securities, and not cash, but not to exclude cash-specific issues altogether.

Derivatives: some felt that all financial instruments, especially including derivatives, should be considered, provided that they are as much susceptible to clearing and to settlement as instruments more unequivocally to be described as securities. The Group decided not to exclude derivatives from its consideration.

Fixed-income *vs* equity securities: were both to be considered. It had sometimes been said that that fixed-income securities presented far fewer problems than equities.

'Bearer' securities: these are to be included also. The discussion had revealed a range of meanings for the term: to some, it refers to securities that may be held in such a way as to provide anonymity to the holder; to others, securities that have been created in physical form but are transferred through book-entries; to others again, it refers to securities that are created in physical form and which transfer by physical delivery. These last should not normally be considered as part of any holding pattern or systematic approach to settlement, and are outside the scope of enquiry. All others, indeed all securities that listed, on an account, registered, or in any way arranged through a book-entry (and thus including those that have been created in physical form), are inside.

4. ANALYSIS OF THE ISSUES RAISED IN THE COMMUNICATION

The main issues to be addressed are essentially the absence of an EU-wide framework for the treatment of interests in securities held with an intermediary (meaning in this context any person or entity that maintains positions regarding securities by way of book-entry); differences in national legal provisions affecting corporate action processing, such as discrepancies in Member States' laws as to the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g., for the payment of dividends; and restrictions relating to the issuer's ability to choose the location of its securities.

In further detail, these include consideration of: the nature of the investor's rights in relation to securities held in an account with an intermediary; the transfer of these rights; the finality of book-entry transfers; the treatment of upper-tier attachment; investor protection from insolvency of the intermediary; the acquisition of these rights in good faith by third parties; differences in the rules relating to the transfers of ownership for the purposes of corporate actions, to the extent that these differences are incorporated in national laws; the choice of securities location.

The Commission had intended that identifying the detail of the work, and in particular the articulation in legal terminology of the specific issues to be addressed, would be a matter for the group itself, drawing for that purpose on its depth of professional expertise. It was noted that the essential range of issues reflects both those treated in the first and second reports of the Giovannini Group on EU Clearing and Settlement (2001 and 2003), and also those set out in the Commission's Communication on Clearing and Settlement, (adopted in April 2004).

A further elaboration of issues in this area had been set out in contributions made by members of CESAME (BNP Paribas, Citigroup, ESF, Euroclear). These had been made available to Group members.

4.1. Preliminary sighting of major obstacles in practice

Views were exchanged on which of these issues or specifications of issues occur most prominently in practice.

One area was the fact that national legal regimes have different concepts of investors' rights. For example, the distinction between rights held on trust and those established by mandate are difficult to reconcile. So too are questions of entitlement.

The situation under the law of France was illustrative: securities there have been completely dematerialised for 20 years. Nonetheless, reform is seen as desirable in order to integrate in one coherent and accessible set of provisions rules which are today dispersed among various legal instruments while continuing to emphasize in relation to issuers direct rights of holders of book entry securities, something which is deeply rooted in company law. The transfer of ownership rules has recently been modified with the aim to promote uniformity: previously there were 3 different modes of transfer. Finality of book entries has been addressed. On the whole, the French system is modernised domestically; but a higher level of clarity about the treatment of foreign securities remains desirable.

In Greece, the national legal regime for securities and settlement is quite modern and works well. But the Bank of Greece has two types of accounts: omnibus and individual, for neither of which is there sufficient clarity on how to handle non-Greek securities.

In Italy, there has been a movement towards a proprietary system, in order better to protect investors. But cross-border transfers involve uncertainty, as do definitions of non-Italian securities, such as *Wertpapiere* or “Electronic negotiated instrument”.

It was helpful to consider these issues from a risk perspective: what risks are associated with a book-entry? There are potentially both counterparty risks and market risks involved.

It was not excluded that the specific legal barriers to cross-border clearing and settlement might turn out to be less severe than anticipated.

4.2. Identifying the issues

A thorough inventory should be made from perusal of the many other relevant published papers, to ensure that all material issues had been taken up. After discussion, the headline questions, around which the questionnaire to be issued would be clustered, were identified as:

- “What rights arise in connection with securities involving book-entries?”
- “What rules apply relating to finality?”
- “How may those rights be transferred? (And how are *bona fide* acquirers protected?)”
- “How can an investor ‘represent’ the rights he has? Can he sell them directly, or only through a nominee? What rights arise for shareholders in dematerialised securities?”
- “Is there protection for the investor from the insolvency of the intermediary?”
- “How are foreign securities, or foreign intermediaries treated?”
- “What rules dictate choice of securities location?”
- “What are the legal implications of arrangements where accounts at CSDs are maintained for individuals?”

4.3. Completing the analysis - the way forward

There being clear agreement that as a first stage the Group needs to collect and/or verify data, and do so comparatively, a questionnaire would be needed.

The task was recognized as especially delicate, in that rights to securities are themselves so variant that there is not even a common vocabulary to describe them. That, too, should be aimed at.

The questions to be posed, clustered as agreed above, will need unashamedly to risk overlap with each other. It will be sensible to ask about the content of each EU national legal regime (and thus take a theoretical, doctrinal approach); and to ask about specific problems in practice, based on typical fact patterns; and to ask about special laws relating to (I)CSDs; and to restrictions on the location of securities; and about corporate action processing.

5. WORKING METHOD

5.1. Timetable

A large amount of work is required to start immediately. This is essential, as the industry have broadly endorsed the Giovannini conclusions, including that law reform is needed, since April 2003. Of course these conclusions need to be systematically validated: the demands of good policy development require nothing less. But there is a need for speed.

Provisionally, it was noted that a possible timetable could be to settle the wording of a questionnaire during February, answer and assess the core responses and collect responses from non-members where appropriate during April and May, including at the Group's meeting on 21st April, take into account the UNIDROIT committee of governmental experts in May, discuss further at the Group's third meeting, 23rd May, and aim to have all answers moderated and analysed, and a draft report for the Group to debate, at its July meeting, on the existence and materiality of issues. This would imply that the Group could propose solutions for discussion with others shortly after the summer holidays, and aim to issue a final Report proposing solutions before the end of the year.

Any further work depends so completely on what solutions will be proposed that it would be fanciful to lay down any timetable for their execution, at least until they are reasonably in prospect.

5.2. Openness; website; consultation

The Group's mandate specified that it is intended that the work of the Group will benefit throughout from views both of members and of non-members, in order to obtain the perspectives of both specialists and non-specialists in industry, public sector and academia, and to draw inspiration from the full range of legal systems found within the EU; the full range of holding and settlement arrangements, including both those direct and indirect; and the full range of perspectives on the law relating to the settlement of securities, including of those engaged in the settlement and custody industry; in securities transactions more widely, in banking, funds and investment; and in considering issues related to investor protection and financial stability.

It was emphasized that the approach of the Group as a whole and of the members individually should be open and inclusive. The work will be conducted primarily by email, members being encouraged always to include all other members on their emails. Members could and should discuss the project with each other and, on an ad-hoc basis, with others interested in the project, both domestically and wider. However, to ensure consistency of overall perceptions, the Secretariat will be responsible for explaining and promoting the project, and consulting systematically with industry, the public sector and academia.

Hand in hand with openness goes the desire not to duplicate. A great deal has already been written on the legal aspects of securities accounts, and clearing and settlement. Existing materials should be collated, and previous findings should be summarized, to form a suitable backdrop to the Group's work. The Group will develop a review of these matters to this end.

When putting forward information about the content of a national legal regime, all members with expertise in that regime will aim to collaborate.

It is intended, in parallel with the working method of CESAME, which had been praised, to post onto the Group's webpage the meeting papers, including the minutes, and papers submitted to the group's work by members and by non-members.

[The webpage has since been established, and may be found at http://europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm.]

5.3. Liaison with others that have undertaken any similar work on the wider global level

The Group's mandate requires it to liaise with others that have undertaken any similar work at the wider global level, where to do so would assist in ensuring the consistency of initiatives in the EU with those developed at international level.

One such initiative is that of UNIDROIT, the International Institute for the Unification of Private Law. UNIDROIT is an independent intergovernmental organisation whose purpose is to study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States. UNIDROIT is based in Rome. 59 countries are member states of UNIDROIT, including all EU member states except Latvia and Lithuania. The EU is not a member of UNIDROIT.

On 23 December 2004, UNIDROIT released a "Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary", together with explanatory notes. The draft Convention will be negotiated during a protracted process, starting with a meeting of a committee of government experts on 9 May this year. Generally, the draft Convention covers much the same ground as the Legal Certainty Group is mandated to cover: harmonisation of certain elements of substantive laws applicable to the cross-border holding and transfer of indirectly-held securities. Thus, both the draft Convention and the Legal Certainty Group deal with an area of law not yet generally covered by Community legislation, but within which there are some specific Community provisions already in existence.

The draft Convention is the product of a Study Group that has been active since 2001. Three members of the Legal Certainty Group have been closely involved: Guy Morton and Philippe Dupont are on the UNIDROIT Study Group; and Antoine Maffei chairs the UNIDROIT capital markets liaison group. Collectively, then, there is a good understanding of the project available to the Group. Those of the Group's members most intimately involved with the UNIDROIT project undertook to make a short briefing paper about it, which would describe the current draft convention, the approach taken in its drafting, and the interplay between it and existing Community law.

It was noted that the UNIDROIT, having been engaged for a few years on the project, might have a wealth of research material that would be both relevant and useful, if it could properly be made available.

It was queried how the Commission, in establishing the Legal Certainty Group, would avoid duplication of effort. It was noted that the two are not identical: UNIDROIT takes

a global view; the Group looks at the problematic from the EU perspective. The EU is unusually sophisticated in its existing legal framework in connected areas, see for example the Settlement Finality Directive and the Financial Collateral Directive. The EU, and thus the Group, look also at slightly wider issues: corporate action processing, which links to our work on company law and corporate governance; and securities location, which is an issue relating to barriers to integration. And UNIDROIT is stopping at the level of a set of legal principles, rather than drafting specific legal rules; the Commission might identify, on advice of this Group, a need for specific legal rules. For all these reasons, the two are not duplicative: they are likely to be complementary. Accordingly, the Group is mandated to liaise with UNIDROIT.

It was clear that the Group should aim to benefit from the work of UNIDROIT. In addition, the Commission is considering seeking for itself a negotiating mandate, as triggered by the existence of overlaps between what the draft UNIDROIT Convention proposes and existing provisions of Community law. This matter would be presented to Member States at the European Securities Committee on 23 February.

However, caution is also needed: previous drafts of the Convention have, for some, raised more questions than answers; and the EU should not limit itself to looking at work prepared by others work.

6. ANY OTHER BUSINESS; FUTURE MEETINGS

The next meeting is provisionally arranged for 21 April in the Commission premises in Brussels. Subsequent meetings in 2005 are tentatively planned for 23 May, 18 July and 19 September.

ANNEX: THOSE ATTENDING

Group Members.

Note: membership of the Legal Certainty Group is personal, not representative. The institutions from which the Group's members are drawn are mentioned here in order to indicate the wide range of relevant expertise with which the Group has been constituted.

AFRELL, Lars, Ministry of Finance, Stockholm
CHRISTMANN, Olaf, Deutsche Bundesbank, Frankfurt am Main
COLOCASSIDES, Georghios, Georghios Colocassides & Co., Lefkosia
DEVOS, Diego, Euroclear Bank, Brussels
DUPONT, Philippe, Arendt & Medernach, Luxembourg
EIHENBERGA, Solveiga, Riga Stock Exchange, Riga
GANADO, Max, Prof. J.M. Ganado & Associates, Advocates, Valletta
GOMEZ-SANCHA, Ignacio, Iberclear, Madrid
KINK, Ahto, OMX Tallinn
LAUHA, Janne, NCSD/Finnish Central Securities Depository Ltd, Helsinki
LAWLESS, Judith, McCann FitzGerald, Dublin
LENER, Raffaele, Freshfields Bruckhaus Deringer, Rome; and University of Rome Tor Vergata, Rome
LÖBER, Klaus, European Central Bank, Frankfurt am Main
LOIACONO, Dario, Loiacono e Associati, Milano
MAFFEI, Antoine, De Pardieu, Brocas, Maffei, Paris
MALICH, Martin, Czech Securities Commission, Prague
MORTON, Guy, Freshfields Bruckhaus Deringer, London
MOTANI, Habib, Clifford Chance LLP, London
PÖCH, Peter, Ortner Pöch Foramitti Rechtsanwälte GmbH, Vienna
SOBOLEWSKI, Ludwik, National Depository for Securities (KDPW SA), Warsaw
STASEVICIUS, Giedrius, Lideika, Petrauskas, Valiunas Ir Partneriai, Vilnius
THAN, Jürgen, Attorney-at-law, formerly Dresdner Bank AG, Frankfurt am Main
TSIBANOULIS, Dimitris, Tsibanoulis and Partners, Athens
VIDA, Mariann, Attorney-at-law, Central Depository and Clearing House, Budapest
ZIEHMS, Linda, Group Deutsche Börse, Frankfurt am Main

Commission personnel:

Alexander SCHAUB (for part only), Director-General, Internal Markets and Services

Pierre DELSAUX (Legal Certainty Group Chairman), Head of Company law, corporate governance and financial crime Unit, in the Commission's Directorate for Free movement of capital, company law and corporate governance

Mario NAVA, Head of Financial Markets Infrastructure Unit

Legal Certainty Group Secretariat: Martin THOMAS (Secretary); Klaus LÖBER; Konstantinos TOMARAS.

Other Commission personnel in the Financial Markets Infrastructure Unit: Juan ARTEAGOITIA; Cedric CALLENS; Eric DEGERBECK;; Doris KOLASSA; Jenni KOSKINNEN; Salvatore LO GIUDICE; Angela LOWE; Tomas THORSEN

Paolo SANTELLA, Company law, corporate governance and financial crime Unit

John BERRIGAN, Head of the Financial Markets and Financial Intermediaries Unit, Economic and Financial Affairs Directorate-General, (Secretary of the Giovannini Group and a member of CESAME)

March 2005