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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  
Draft UNIDROIT Convention on harmonised substantive rules  
regarding securities held with an intermediary**

The views of the Legal Certainty Group on the draft UNIDROIT Convention are sought for three inter-related reasons.

First, the Group is required by its mandate to liaise with UNIDROIT. Secondly, since the Commission had been invited to designate observers to attend UNIDROIT on May 9<sup>th</sup>, it is sensible to ask the Group to give informal assistance through the provision of advice to the Commission on specific technical issues arising out of the UNIDROIT draft. Thirdly, informally, we understand anecdotally that a number of members of the Group have been asked by the governments of the Member States in the laws of which they are expert to represent those Member States at the UNIDROIT committee of governmental experts on May 9<sup>th</sup>.

In this note, we suggest that the Group approach the draft UNIDROIT Convention on harmonised substantive rules regarding securities held with an intermediary in four strands:

- issues relating to the absence of an EU-wide framework for the treatment of interests in securities held with an intermediary, in particular the holding and transfer of interests in securities.
- issues relating to systemic stability
- issues relating to collateral
- any other issues arising

The text of the draft Convention is set out in this note. As members are already aware, it is also available, together with an explanatory report, on the UNIDROIT website. In addition members have received a note about the draft UNIDROIT convention from Guy Morton, Philippe Dupont and Antoine Mafféi dated 7 February 2005 (also posted onto the Group's webpage).

**1. ISSUES RELATING TO THE ABSENCE OF AN EU-WIDE FRAMEWORK FOR THE TREATMENT OF INTERESTS IN SECURITIES HELD WITH AN INTERMEDIARY, IN PARTICULAR THE HOLDING AND TRANSFER OF INTERESTS IN SECURITIES.**

Is the definition of securities in the Convention appropriate for the Legal Certainty project? Should it be understood as to encompass e.g. all kinds of derivatives or participation rights in companies or limited to those capable of book-entry?

Article 2 establishes that rights arise from the credit of securities to a securities account, in particular the right “to receive and enjoy the fruits of ownership”. This essentially combines the notion of the asset with the notion of the record identifying the owner of the asset. It thus matches the recommendation set out in the Giovannini reports. Is it acceptable in principle as the basic mechanism for an EU-wide framework for the treatment of interests in securities held with an intermediary?

Are the notions of “relevant intermediary” and “account holder” as used in the context of Art. 1, 8, 11, 15 and 17 appropriate for the Legal Certainty project?

Article 2(1) (d) establishes a right, by instructions to the relevant intermediary, to withdraw the securities so as to be held by the account holder otherwise than with an intermediary, to the extent permitted under the applicable law. Is this desirable from the perspective of the legal framework of the EU?

Is the limitation that restricts the enforcement of rights by the investor to those asserted against the intermediary (Article 2 (2)) satisfactory from the perspective of the legal framework of the EU?

Are the scope of obligations and liabilities of the intermediary as contained in Art. 2(3)(b) seen appropriate from the perspective of the legal framework of the EU?

Are the description of the functions of credit and debit for the acquiring and disposal of rights and the lack of a nexus of credit and in Art. 3(1)-(4) seen appropriate from the perspective of the legal framework of the EU, also with the interaction with Art. 5 (authorisation by the holder, conditionality, reversal of bookings)? Should there be a special focus on the validity of bookings?

Are the concept of reversals (Art. 5(3) to (5)) appropriate?

Is the concept of acquisition by an innocent person (Art. 10) appropriate?

Are the rules on the safeguarding of sufficient securities to cover the holdings of investors (Art. 14) seen as being appropriate, taking into account the concept of required “immediate action” (Art. 14(2) and 14(6))?

Are the rules on the allocation of shortfalls (Art. 16), referring e.g. to the system rules or a pro-rata allocation seen as being appropriate project?

What is desired in relation to the set-off provision (Art. 18)? Should opportunities for set-off be enhanced or modified?

## **2. ISSUES RELATING TO SYSTEMIC STABILITY**

What is the interrelation of the concept of effectiveness (Art. 5 and 6) and of finality and what is the interaction with the Settlement Finality Directive?

The draft Convention uses differing concepts of finality, either explicitly (Art. 6, 12(1)) or implicitly (Art. 5: “effectiveness”), which do not fully match the structure of the Settlement Finality Directive. Is this sufficient from the perspective of the legal framework of the EU?

Are the scope of rules covered regarding the protection of the stability of systems and extent of their application (Art. 7) seen as being appropriate in the context of the Legal Certainty project, also in view of the Settlement Finality Directive?

To the extent that Articles 7 and 12 of the draft Convention introduce the expression “rules directed to the stability of the system”, it is necessary to ensure that there are no unwarranted repercussions arising from this comparatively broad phrasing being interpreted divergently. What is the view of the members of the group on this topic?

Is the definition of system (Art. 7) seen to be satisfactory in the context of the Legal Certainty project, also in view of the Settlement Finality Directive?

As regards the definition of system, it is uncertain whether the draft Convention (Articles 7 and 12 and the respective explanatory comments, for instance the reference to ‘several participants’) is in line with the concept of “system” that is applied in the Settlement Finality Directive. In this context it may be noted that, although the overall concept appears similar, the concept of a ‘system’ in Article 2 (a) of the Settlement Finality Directive is fully articulated, whereas the specific limits of the concept are left undefined in the draft Convention. In the explanatory comments to Article 7 of the draft Convention, reference is made to “standardised operational practices for the execution of transactions”, which may be contrasted with the Settlement Finality Directive expression, “standardised arrangements for the execution of transfer orders”, “transfer orders” being a defined term in that Directive (at Article 2(i)). What is the view of the members of the group on this topic?

## **3. ISSUES RELATING TO COLLATERAL**

Are the methods to create security interests (Art. 4) seen as being sufficient from the perspective of the legal framework of the EU, particularly taking into account the absence of any requirement to notify third parties (Art. 4 (2))?

Are the rules regarding the priority of transfers and security interests established by way of book-entry (Art. 3(6) and (7), Art. 4(5), Art. 9) seen as being appropriate from the perspective of the legal framework of the EU?

How do the rules on collateral transactions (Art. 19 – 22) interaction with the Collateral Directive, in particular regarding the scope of application?

Articles 19 to 23 of the draft Convention aim broadly to track the corresponding provisions of the Financial Collateral Directive. However, as the drafting used is not exactly the same, there are a number of possible divergences. It is to be noted that the

draft Convention is broader than the Financial Collateral Directive, as it encompasses natural persons and rating-related top-up collateral. Is this to be resisted?

#### **4. ANY OTHER ISSUES ARISING**

There are a number of overarching issues. Comments on them are welcome if thought useful. These issues include: what is the degree of interaction between the scope of the Convention and scope of the Legal Certainty Project, the Collateral Directive, and the Settlement Finality Directive? What would be the interrelation with other EC Directives, e.g. MIFID definitions?

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