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LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

Important comment: this document is a working document of the Internal Market and Services Directorate General of the European Commission for discussion and consultation purposes. It does not purport to represent or pre-judge the formal proposal of the Commission.

CONSULTATION DOCUMENT OF THE SERVICES OF THE DIRECTORATE-GENERAL INTERNAL MARKET AND SERVICES

1. This public consultation has been prepared by the services of the Internal Market Directorate General of the European Commission. It seeks feedback from Member States, market participants and other stakeholders, including investors, on improving the legal framework for holding and disposing securities and the exercise of rights attached to securities in the context of the Internal Market. Although the issue and any possible solutions are legal in nature, the underlying problems have a significant economic impact. The present lack of legal clarity and certainty in the field covered by this consultation has a concrete impact on cross-border investment in Europe. Any future legislation in this field will need to complement and will be without prejudice to the existing EU legal framework concerning, for instance, markets and trading in financial instruments (cf. Directive 2004/39/EC – MiFID – and its implementation measures).

PRELIMINARY REMARKS

2. In 2004, the Commission set out a roadmap for future action with a view to enhancing the safety and efficiency of post-trading arrangements across Europe[1]. It

[1] "Clearing and Settlement in the European Union – the way forward", Communication from the Commission to the Council and the European Parliament, COM (2004) 312 final, 28.04.2004.

advocated, amongst other proposals, pursuing work in the field of legal barriers to a safe and efficient post-trading landscape. It mandated a group of legal experts, the Legal Certainty Group, to advise the Commission Services on whether legislation in the field of securities holding and dispositions should be improved, and if so, how it should be carried out. The Group presented its Advice to the Commission in August 2008[2] and was also the subject of a public conference held on 23 October 2008 in Brussels.

3. A *first* public consultation on this issue was held between 16 April and 11 June 2009. The Services prepared a first set of draft provisions which were discussed with Member States' experts between February and June 2010. In view of the progress of discussions and further reflection on legal details, the Commission services would like to submit the outcome of this process to a *further* public consultation.

4. This consultation paper contains 22 sections which cover the full scope of the possible legislative approach. Note, however, that some issues that were raised in the first consultation paper, notably the issue of free access to CSDs by issuers, will be dealt by a separate strand of work.

5. ***Importantly, the approaches and suggestions contained in this paper remain work in progress and are exclusively published for discussion and consultation purposes. It does not purport to represent or pre-judge any possible formal proposal of the Commission***.

6. This consultation will open on **05/11/2010** and close on **01/01/2011**. Answers, to one or several of the questions below, can be submitted to markt-consultation-sld@ec.europa.eu

7. Contributions, together with the identity of the contributor, will be published on the website of the Directorate-General for Internal Market and Services, unless the contributor objects to their publication.

INFORMATION ABOUT THE RESPONDENT

In order to correctly assess responses received, respondents are requested to provide the following information.

- Name and address of the respondent
- Field of activity of the respondent
  - Does the respondent (or in the case of an association, its members) conduct domestic or cross-border securities operations in the EU/EEA area?
  - If yes, in which form does your entity conduct these operations?
- If the respondent is a securities account provider, please indicate whether the activity relating to holding and dispositions of account-held securities is

[2] "Second Advice of the Legal Certainty Group on Solutions to Legal Barriers related to Post-Trading within the EU, August 2008, http://ec.europa.eu/internal_market/financial-markets/clearing/certainty_en.htm.

– made in the context of a European regulated activity (e.g. banking and/or investment services);

– made in the context of national regulations (e.g. for the service of safekeeping of securities; or as a CCP, SSS or CSD authorised or supervised by a public authority).

- If the respondent is an association of stakeholders, how many members do you represent and what is your membership structure?

QUESTIONNAIRE:

This paper presents specific and articulated principles which are followed by an explanation for those principles. As the Commission's first public consultation of 2009 already presented the general issues at stake and sought feedback at a high-level of generality on the possible approaches, this paper, of necessity enters into greater detail and granularity. This avoids duplication of the issues discussed during the first public consultation. A glossary of terms is included at the end of this Paper to assist stakeholder in understanding the precise meaning of the terms adopted.

1 – Objectives

1.1 Principles

1. EU law should regulate the legal framework governing the holding and disposition of securities held through securities accounts and the processing of rights flowing from securities held through securities accounts.

2. The legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities.

1.2 Background

The last forty years have been characterised by the sharp development of book-entry securities to the detriment of paper based securities. Today, throughout Europe, depending on the Member States and on the type of securities (listed or not listed) the percentage of securities entered into a book-entry form varies from 100% to 85%[3]. Usually, the more recent the financial market, the more it is dematerialised. This phenomenon is addressed through different terms ("dematerialisation", "immobilisation", "registered form", "electronic book-entries"), which address different approaches and legal issues but which all converge on a situation where securities are no longer transferred in paper form but through securities accounts kept by account providers acting on behalf of account holders. Whereas, in the past, securities were transferred from "hand to hand", today, securities are mostly transferred by "book-entries", requiring the recourse to a "securities account" and the intervention of a third party, the "account

[3] "Summary of the First Public consultation on the harmonisation of securities law", April-June 2009, http://ec.europa.eu/internal_market/financial-markets/docs/securities-law/first_consultation_summary_en.pdf

provider", which is an intermediary (often a bank or an investment firm). The same phenomenon exists outside the EU, especially in Switzerland, the US, Canada, Japan, China, Brazil and other developed and emerging markets.

In some national holding arrangement, only one single account provider intervenes in the holding of securities. In other Member States it might be a multitude of "account providers", one holding for the other ("holding chain"). This market reality is usually addressed by the national law. It is important to note that from a *domestic* point of view, most Member States' legislation concerning book-entry securities works perfectly well for *purely domestic* situations. However, the legal frameworks differ considerably. Where a holding chain crosses borders, different laws are applicable to the same underlying securities. Yet, the relevant laws of Member States are usually incompatible and legal uncertainty arises, for example because different laws identify different 'owners' of the same underlying security. This is current legal reality and uncontested amongst legal experts.

As a result, in the EU the cross-border holding and disposition (outright sale, pledge, etc) of securities held through securities accounts across borders:

a. suffers from legal uncertainty and it is often not clear what an investor owns,

b. is ineffective, and

c. does not allow investors to exercise the rights attached to those securities (receipt of dividends or interests, voting, agreeing to corporate measures like stock splits, etc) without major obstacles.

It is therefore necessary to make the holding and disposition safer and easier from a legal point of view by ensuring that the core mechanisms of Member States' legal frameworks are compatible. Some of the difficulties are legal in nature, others are operational. The following three actions are required for consideration:

1) *all* account providers must be regulated at EU-level and should be subject to a detailed authorization and supervision framework notably the one provided by MIFID;

2) conflict-of-laws arrangements (answering the question of which law is applicable) must be clarified and brought in line with existing EU measures (Settlement Finality and the Financial Collateral Directives);

3) substantive law arrangements (answering the question of what the applicable laws say in substance) need to be made compatible;

4) the full exercise of investor rights must be guaranteed.

Of central importance is that measures at EU level should not seek to harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities. It is not only extremely difficult to harmonise the national laws of legal ownership of shares between Member States, but it is also unnecessary. A functional approach should suffice. Equally, EU law should not cover the functions of creation, recording or reconciliation of securities, against the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar.

1.3 Question

Q1: Do you agree that the envisaged legislation should cover the objectives described above? If not, please explain why. Are any aspects missing (please consider also the following pages for a detailed description of the content of the proposal)?

2 – Shared Functions

2.1 Principles

1. It should be possible for Member States to provide that a person other than the account provider is responsible for the performance of certain, but not all, functions of an account provider. In such a case, references made in EU law to an account provider aim at the person responsible for performing the function to which the relevant provision applies.

2. The Commission would need to be notified accordingly and could specify the exact content of the notification. The Commission should publish on its website a list of Member States allowing for the sharing of account-provider functions, including all relevant specifications.

2.2 Background

In some jurisdictions account providers actually share the task of maintaining a securities account with one or even more, other service providers which are not considered as account providers. It is important that EU legislation smoothly applies to such holding patterns. This is in particular the case in "transparent systems" (Sweden, Finland, Greece and others), where by virtue of the national law, the Central Security Depository (CSD) that has entered the securities into a book entry form is considered as the sole securities account provider. All other intermediaries are considered as purely transparent "account operators" which intervene in the managing of the account on a contractual basis, being neither account holder nor account provider.

In these situations there is a need for clarification as to how and to whom the provisions of the envisaged legislation apply. Therefore, there is a need for a mechanism for the identification of

(i) the person who is the account provider of the account holder;

(ii) the functions which are performed by the *other person* (the one which is not the account provider but takes over some functions);

(iii) the provisions of the Convention which apply to that *other person* instead of applying to the account provider.

A main purpose of a specific provision would be to clarify that such holding patterns are actually covered. The principle should contain the following elements (i) it should generally recognise the existence of holding patterns involving shared functions, (ii) it should specify which quality of involvement the other person must have; (iii) it should state that the rules of the envisaged legislation are applicable to that *other* person performing account provider functions; (iii) it should contain an element of publicity, e.g. by notifying the pattern to the Commission.

However, a general identification of such persons on the basis of the terms "outsourcing" or "legal representation" would be insufficient in the view of the Commission Services.

Therefore, the provision should use the criterion of "responsibility" for delimitation. The *other person* should be "responsible" for the performance of a function or functions covered by the envisaged legislation. In that respect, "Responsible" would mean legally responsible vis-à-vis the account holder, i.e. the person must have an own, independent role regarding the fulfilment of the function, including an element of legal accountability towards the account holder.

The envisaged functions of an account provider could probably include: (i) receive and execute instructions; (ii) be the operational addressee for the exercise of corporate rights, (cf. sections 16 to 21).

As the arrangement of shared functions and the application of the envisaged legislation and Member States' law to this situation have a legal effect on third parties, in the view of the Commission's services the sharing of functions should not be left to private contractual arrangements alone. Therefore, sharing functions should be allowed or provided for under the relevant Member State's law.

For the same reasons, arrangements regarding the sharing of functions would need to be made public. A notification to the Commission with subsequent publication in a web-site based list could suffice. The exact content of that notification could contain (a) the class of assets concerned, and, (b) the entities concerned (i.e. who is account provider and who is *the other person*) and their respective share in the functions.

2.3 Questions

Q2: Would a Principle along the lines set out above adequately accommodate the functioning of so-called transparent holding systems?

Q3: If not: can you explain which aspect is not correctly addressed and what could be improved? Which are, if applicable, the repercussions on your business model?

Q4: Do you know any specific difficulties of connecting transparent holding systems to non-transparent holding systems?

3 – Account-held securities

3.1 Principles

1) The national law should clarify that securities standing to the credit of a securities account confer upon the account holder at least the following rights:

(a) the right to exercise and receive the rights attached to the securities if the account holder is the ultimate account holder or if, in any other case, the applicable law confers the right to that account holder;

(b) the right to effect a disposition under one of the harmonised methods (cf. below);

(c) the right to instruct the account provider to arrange for holding the securities with another account provider or otherwise than with an account provider, as far as permitted under the applicable law, the terms of the securities and, to the extent permitted by the national law, the account agreement and the rules of a securities settlement system.

2) The national law should make sure that account holders which act in the capacity of account provider for a third person exercise the rights (b) and (c), above, in accordance with the instructions of that person (see below).

3) In case of acquisition of a security interest or other limited interest in account-held securities the national law of should be able to restrict the rights (a)-(c), above.

4) The national law should be allowed to characterise the legal nature of account-held securities as any form of property, equitable interest or other right as far as the characteristics flowing from the legal nature is in accordance with the rights (a)-(c), above, and the remainder of any legislation.

3.2 Background

The most relevant aspect of any legislative action in the field of securities held through account providers would certainly relate to the requirements which need to be fulfilled in order to render the acquisition of securities or of a security interest in securities, legally effective (see sections 4 *et seq.*, below). However, the certainty that an account holder acquires such position must be accompanied by the knowledge of what he has exactly acquired. This is because account holders need to be sure to what extent the acquired position can be used: to participate in a corporation, to receive dividends or similar payments, to sell the securities or realise their value in case a security provider does not fulfil his obligations, etc.

The legal design of the acquired position must provide clarity regarding these elements. To this extent, and as confirmed by stakeholders in the first public consultation, there is a clear need for harmonisation. Consequently, a common legal framework could provide for a legal position of the acquiring account holder which comprises a set of legal attributes in the sense of a minimum content, without determining the exact legal characterisation of that position. In other words: the common legal framework would not harmonise the property laws of Member States but limit itself to setting out what the attributes of that law would be. This is referred to as a functional approach which should achieve the following substantive elements:

First, the legal nature of the right credited to accounts might change in a holding chain which crosses jurisdictional borders (i.e. with different laws applicable to the various parts of the chain). Account holders might have, in respect of the same underlying securities, conceptually differing rights (full property, shared property, right sui generis, equitable interest) depending on their position in the holding chain and the national law applicable to their accounts. This is the reason for which this second consultation paper continues to refer to the formal envelop of the rights credited to accounts, rather to its actual legal content. However the terms have been changed. While, the first consultation paper of April 2009 referred to the term "book-entry securities", it became clear that "book-entry securities" can be misunderstood. Confusion may arise as to whether Member States were to be required to introduce a new category of securities - book-entry securities - in their legal system. This would not be the case. The concept has therefore been refined and renamed as "account-held securities".

Second, account holders need to be sure *what* they receive. This is because they may expect to be able to use the asset in one or more ways (participate in a corporation, receive dividends or similar payments, sell the securities, use them as collateral or realise their value in case a security provider does not fulfil his obligations, etc.) Consequently,

legal framework must provide for a legal position that is harmonised in the sense that the account holder receives these essential elements of minimum content. As the applicable law would remain national law, a legal approach must focus solely on achieving this result without determining the exact legal characterisation of the acquired position. The most important elements are the following:

– the ultimate account holder can exercise the rights flowing from the securities (dividends, voting rights); "non-ultimate" account holders can exercise the rights only if so determined by the national law (e.g. because they are identified by the national law as "shareholder"), which is actually often the case under the current legal arrangements. EU law addressing the exercise of rights would be in a position to guarantee that the ultimate account holder at least controls the exercise of the rights, cf. below, sections 15-20;

– any account holder can 'dispose' of the securities, i.e. relinquish them or use them to provide a security interest, however, if he is not the ultimate account holder, he can do so only on instruction (see paragraph 2);

– an account holder must be able to change the holding situation (which does not represent a 'disposition' in the sense of the second indent) either by moving the securities to another account provider or by retrieving certificates (to the extent that this is possible under the applicable law and other relevant rules).

Third, Where a crediting occurs with a view to creating a security interest (pledge *et.al.*, or other limited interest, like usufruct), it is necessary that the applicable law can restrict the right to exercise the corporate rights or dispose of the security, (depending on the nature of the interest, e.g. pledge as opposed to repo).

Fourth, There is agreement that it would be too complicated (and unnecessary) to conceptually harmonise Member States' laws on the above issues.

Therefore, the applicable (national) law remains decisive for the legal nature of the right acquired by an account holder upon crediting of the account. For example, where the applicable law qualifies the right of an account holder as a classical property right, the legal position (a) can be called "property", (b) must cover the minimum content described above, and, (c) can additionally have legal attributes that property in this jurisdiction normally has. However, (a)-(c) are subject to the requirement that neither the legal qualification nor the attributes coming with it can contradict the remainder of the common legal framework. This principle applies regardless of the qualification of the right under national law as 'property', 'property sui generis', "equitable interest" or other, (see paragraph 4 of the draft Principle).

This principle refines the understanding of who is potentially identified as the person called upon to exercise the rights flowing from the securities by the applicable company law. In some situations, company law attributes the exercise of the rights to an account holder which is not the ultimate account holder of the securities in question but one of the account providers involved in the holding chain (in particular if the company register determines the shareholder), see paragraph 1(a). This needs to be taken into account. As a consequence the case of the 'non-ultimate' account holder entitled to exercise the rights needs to be included explicitly, in order to respect national company law analysis.

In all cases, the envisaged principles on the exercise of corporate rights, (see below principles 15 to 20) guarantee that the ultimate account holder either exercises itself or is at least in control of the exercise by the legal holder.

3.3 Questions

Q5: Would a principle along the lines described above provide Member States with a framework allowing them to adequately define the legal position of account holders?

Q6: If not, which legal aspects that belong, in your opinion, to an adequate legal position of each account holder could not be realised by the national law under an EU framework as described above? What are the practical problems that might occur in your opinion, if Member States were bound by a framework as described above? Which are, if applicable, the repercussions on your business model?

Q7: The Geneva Securities Convention (www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm) provides for a global harmonised instrument regarding the substantive law (= content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing this subject. Most EU Member States and the EU itself have participated in the negotiations of this Convention. Both the present approach and the Convention are compatible with each other.

- If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?

- Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?

4 – Methods for acquisition and disposition

4.1 Principles

1. The national law should provide for acquisitions and dispositions of account-held securities and limited interests therein to be effected by crediting an account and debiting an account respectively.

2. The national law should provide that an account provider may credit the accounts of its account holders, for each description of securities, only if it holds a corresponding number of securities of the same description by

(a) having available account-held securities in a securities account maintained for the account provider by another account provider;

(b) arranging for securities to be held on the register of the issuer in the name, or for the account, of its account holders;

(c) holding securities as the registered holder on the register of the issuer;

(d) possessing relevant securities certificates or other documents of title; or

(e) creating the initial electronic record of securities for the issuer in accordance with the applicable law.

and that an account provider continuously holds that corresponding number.

3. If the applicable law allows crediting and debiting to be made conditional it should also define the extent to which such conditional crediting or debiting is taken into account in determining the number of securities referred to in the preceding paragraphs. Credits to a securities account the effectiveness of which is subject to a condition must be identifiable as such in the account.

4. If a corresponding number (paragraph 2) is not held, the account provider should promptly apply either or both of the following mechanisms in order to re-establish compliance:

(a) reverse erroneous credits;

(b) provide additional securities of the relevant description, to be held by one of the methods provided for in paragraph 2.

The sharing of any cost entailed by the provision of additional securities pursuant to sub-paragraph (b) can be subject to a contractual agreement between the account provider and those account holders holding securities of the relevant description at the time of the occurrence of the loss in non-segregated accounts only in cases where the account provider held securities of the relevant description with another account provider pursuant to Article 17(3) subparagraphs (a) and (b) of the MiFID.

5. The applicable national law may in addition allow for acquisitions and dispositions being effected under one or more of the following methods:

(a) earmarking account-held securities in an account, or earmarking a securities account, and the removing of such earmarking;

(b) concluding a control agreement; or

(c) concluding an agreement with and in favour of an account provider.

4.2 Background

There is general agreement that a separation in two distinct principles is logical. A first principle should deal with the operational side of acquiring and disposing through accounts, comprising the methods for acquisition and dispositions and the corresponding duties of the account provider. A second principle should set out the requirements for the legal effectiveness of acquisitions and dispositions, under regular circumstances as well as in situations in which the account provider is not compliant with the operational duties. Methods are addressed in the present section, legal effectiveness in the following sections.

Different methods are used throughout Member States to realise one or the other type of acquisition and disposition.

- Book-entry methods

- crediting of an account;
- debiting of an account;
- earmarking of securities in an account or of a securities account;
- removing of an earmarking.

– Non-book-entry methods
  - conclusion of a control agreement;
  - conclusion of an agreement with and in favour of the account provider.

There is a general agreement that among these six book entry methods, crediting and debiting form the minimum common denominator that should be generally provided for under any law (see paragraph 1). The four other methods should be recognised in a cross-border context but not necessarily imposed or allowed to local account holder – account provider relationships (see paragraph 5).

In particular crediting and debiting determine the actual number of securities in the holding chain and must be used consistently and in such a way that the number of securities maintained by the account provider for the account of its account holder always equates the number of securities held by the former through one of the five methods distinguished under paragraph 2. As a matter of fact, instead of providing for a rough ex ante "no-credit-without-debit-rule", that is difficult to address in legal terms (civil law cannot forbid neither "error" nor "fraud"), the Commission Services suggests having recourse to an ex post rule as provided under paragraph 2 seeking the final *result* rather than detailing the initial *methods*. Furthermore, this ex-post solution allows the identification of two corrective methods in case of shortfall, as provided under paragraph 4.

Only in limited circumstances involving crossborder holdings with third countries (notably cases regulated under Article 17 (3) of the MiFID Implementing Directive), it might be worth considering the sharing of costs between the account holder and the account provider. This is the purpose of the last indent of paragraph 4 of the draft Principle.

As concerns paragraph 3 concerning "conditional credits", it must be read in conjunction with Principal 5 paragraph 6 (see below)

4.3 Questions

Q8: Would a principle along the lines described above allow for a framework which effectively avoids that more securities are credited to account holders than had been originally issued by the issuer?

Q9: If not, how could a harmonised EU-framework better guarantee that account providers do not create excess securities by over-crediting client accounts (keeping in mind that all account providers are either banks or MiFID regulated entities)? Please distinguish between regulating the account providers' behaviour and issues relating to the effectiveness of excess credits made.

Q10: Is the principle relating to the passing on of costs of a buy-in appropriate? If not, in which way should it be changed and why? What would be the repercussions on your business model?

5 – Legal effectiveness of acquisitions and dispositions

5.1 Principles

1. The legal nature of dispositions over account-held securities effected under one of the methods listed in Principle 4 would be determined by the national law, as far as the legal nature does not contravene the principles.

2. No further steps than those set out in Principle 4 paragraphs 1 and 5 should be required to render an acquisition or disposition effective between the account holder and the account provider and against third parties.

3. To the extent that the requirements of Principle 4 paragraph 2 are not met, and until measures under Principle 4 paragraph 4 are successfully applied, the national law, or the rules of a settlement system in accordance with the applicable law, should determine, subject to Principle 8 below, whether and in what circumstances a credit is legally ineffective, liable to be reversed or subject to a condition, and the consequences thereof.

4. Acquisitions and dispositions arising by mandatory operation of the national law are effective and have the legal attributes, in particular rank, attributed by that law.

5. Effectiveness in the above sense does not determine whom an issuer has to recognise as legal holder of its securities.

– 6. The effectiveness can be made subject to a condition in accordance with national law.

7. The national law prescribes whether the credit is legally ineffective, liable to be reversed or subject to a condition, and the consequences thereof if the terms of issue of the relevant securities, in accordance with the national law under which the securities are constituted, require the agreement of the issuer for an acquisition to be legally effective.

8. The national law may provide for reasons which trigger ineffectiveness of acquisitions and dispositions effected under a control agreement or an agreement with and in favour of the account provider and regulate the consequences of such ineffectiveness.

5.2 Background

As regards the side of legal effectiveness of acquisition and disposition, certainty requires the assurance that, from a specific point in time, acquisitions and dispositions can no longer be “undone” and are “good against” third parties. Acquisitions and dispositions should be effective once they are established under one of the six methods set out above, establishing at the same time the effectiveness between account holder and account provider, the effectiveness against the insolvency administrator and the creditors in any insolvency proceeding and the effectiveness *vis-à-vis* third persons. This is the purpose of Paragraphs 1 to 2.

In this respect, there is agreement regarding the principle that if an innocent account holder is protected against reversal of earlier credits a solution is required as regards the avoidance of the creation of "legally effective excess securities". This question can

however be left to the applicable (national) law. However, every national rule must effectively avoid legally effective excess securities.

Paragraph 6 deals (together with paragraph 3 of Principle 4) deals with Conditional Credit. Conditional credits are used in particular in the context of contractual settlement, i.e. an agreement between account provider and account holder under which the account holder immediately receives the acquired securities, even if the account provider has not yet received them (in particular because the settlement cycle is T+2 or T+3). Typically, Member States' law determines that the credit is not legally effective until the account provider receives the securities through the settlement system. In more general terms, conditional credits establish a linkage between effectiveness of a book entry and factors external to the account. Therefore, 'Conditional credits' should be possible under the applicable law. But since, conditional credit is an exception to the principle of effectiveness; it has to be identified marked accordingly in the book-entry system. This is the reason for which Paragraph 3 of Principle 4 provides that "credits to a securities account the effectiveness of which is subject to a condition must be identifiable as such in the account."

A recognition of conditional credits leads to a situation where two different types of credit can be made to an account: the "regular" credit having immediate effect, and the conditional credit which is not immediately effective. For this reason, conditions should be made transparent from the account (which would create additional administrative burden for the account provider) or at the least limited in time, (cf. Section 5 Paragraph 3 of the principle*)*. A non transparent condition in itself may not be an issue as long as the effects are confined within one system or intermediary, for instance by blocking conditional credits until the condition is fulfilled. However, if such non-transparent conditional credits could be passed down a chain of intermediated holdings into a jurisdiction where credits are always legally effective in the moment they occur, creation of uncovered excess-securities might be the result.

Some Member States allow for "restricted registered shares". Under this regime, the terms of the issue can provide that any legally effective acquisition of securities is subject to prior consent of the issuer. Until the consent is given, the securities are not acquired. These regimes should be recognised as part of national corporate law and remain unchanged.

5.3 Questions

Q11: Would a principle along the lines described above provide Member States with a framework allowing them to determine legal effectiveness and ineffectiveness to an extent sufficient to safeguard basic domestic legal concepts, like e.g. the transfer of property?

Q12: If not, please specify how and to what extent national legal concepts would be incompatible. Please specify the practical problems linked to these Background, and, if applicable, the repercussions on your business model.

6 – Effectiveness in insolvency

6.1 Principles

1. Acquisitions and dispositions that have become effective under the methods described in Principles 4 and 5 should be equally effective against the insolvency administrator and creditors in any insolvency proceeding.

2. The principle contained in Paragraph 1 does not affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as any rule relating to:

(a) the ranking of categories of claims [in the case of violation of the methods described in Principles 4 and 5];

(b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; or

(c) the enforcement of rights to property that is under the control or supervision of the insolvency administrator.

6.2 Background

The most important aspect here is the protection of account holders' securities in the event of the insolvency of the account provider. Any EU-initiative must make it crystal clear that the insolvency administrator of the insolvent account providers does not have access to the securities or interests therein established by one of the harmonised methods. This protection is probably already implicitly granted by the preceding envisaged Principles. However, because of the overarching importance of this aspect, and in order to remove doubts regarding the question whether the insolvency administrator is a "third party", the insolvency situation should be addressed in an additional, separate rule from the principle presented under question 5 above.

National insolvency law often contains rules targeted at the protection of the creditors of the insolvent entity. In particular, there are rules for the recapture of assets transferred by the debtor to the detriment of his creditors in a suspect period prior to the commencement of the insolvency proceedings, especially in cases of alleged or actual fraud. It should be avoided by any EU-initiative to harmonise or to affect these rules. In addition, there should be no interference with rules on ranking of claims **[**in the case of violation of the methods described above**]** and methods of enforcement in insolvency. As there is a wide range of such rules, there needs to be a rather general statement of this principle, ideally accompanied by rule examples such as the ones provided under paragraph 2 of the principle above.

6.3 Questions

Q13: Would a principle along the lines described above provide for a framework allowing effective protection of client securities in case of insolvency of an account provider?

Q14: If not, which measures needed for effective protection could not be taken by Member States under the proposed framework?

7 – Reversal

7.1 Principle

1. The national law should ensure that Book entries can only be reversed under the following circumstances:

(a) in the case of crediting provided that the account holder consents to the reversal;

(b) in the case of erroneous crediting which was not authorised by the account holder, subject to Article 9;

(c) in the case of debiting which was not authorised by the account holder, or a third person who has acquired an interest in the relevant account-held securities;

(d) in case of earmarking which was not authorised by the account holder, subject to Article 9;

(e) in case of removal of an earmarking which was not authorised by the person in whose favour it was made.

2. Paragraph 1 should be, to the extent permitted by the applicable law, subject to any rule of a securities settlement system.

3. The national law should specify the extent to which consent in the sense of paragraph 1(a) can be given in a general manner and any formal requirements for giving such consent.

7.2 Background:

In parallel to the principle of effectiveness, once an effective book-entry position is effectively established, there needs to be clarity on the conditions under which it can be subsequently “undone” and what the legal consequences in such a case would be.

There is general agreement that totally comprehensive effectiveness of acquisition and disposition of account-held securities is unpractical. Therefore, once an effective account-held position is established, there needs to be clarity on the conditions under which it can be subsequently “undone” and what the legal consequences in such a case would be. The future harmonised legislation should therefore provide for reasons allowing for 'reversal'.

The set of reasons allowing for reversal should be very restricted, in order to guarantee maximum certainty regarding the validity of an acquisition. There are a number of cases of possible reversal which are all borrowed from general principles of law and which should be maintained for the area of account-held securities.

First, the obvious exception is that the account holder agrees that a crediting is reversed. Second, it must be possible to reverse a crediting which the account holder did not want to obtain, either because it objected explicitly or because it did not give general or special authorisation to credit securities to its account. Third, where an unauthorised debit violates the rights of the account holder or a third person which had a security interest in

the account-held securities, reversal of the debiting (= re-crediting) must be possible. Fourth, where an earmarking of account-held securities in favour of a third party was not authorised by the account holder, it must be possible to reverse the earmarking (= delete it). Fifth, where a valid earmarking is removed without the consent of its beneficiary (in particular: secured party), the removal can be reversed (= re-earmark).

7.3 Questions

Q14: Is the list of cases allowing for reversal complete? Are cases listed which appear to be inappropriate? Are cases missing? What are, if applicable, the repercussions on your business model?

Q15: Should national law define the extent to which general consent to reversal can be given in standard account documentation? What are, if applicable, the repercussions on your business model in case your jurisdiction would take a restrictive approach to this question and limit the possibility of general consent to reversal?

8 – Protection of acquirers against reversal

8.1 Principle

The national law should ensure that

(a) an account holder is protected against reversal of a crediting;

(b) a person in whose favour an earmarking has been made is protected against reversal of this earmarking

unless it knew or ought to have known that the crediting or earmarking should not have been made.

8.2 Background

A comprehensive legal system on acquisition and disposition of securities requires a rule of "good faith acquisition". In the account-held environment, under the assumption that reversal must be allowed in certain cases, the absence of such a good faith acquisition rule may have very serious systemic consequences. An attempt to unwind a sequence of acquisitions because one of these acquisitions had been invalid could cause serious strain to participants and, possibly, to systems. In most jurisdictions, there are rules in place protecting the parties involved in such a situation against the risk of unwinding a sequence of acquisitions. These rules resemble each other as regards their general result, while differing considerably as regards their exact legal construction, some of them focusing on the contractual liability of the account provider towards the account holder whereas other focus more on the inalterability of the ownership right of the good faith acquirer.

An account holder’s ability to rely on a credit in his account (with limited exceptions) is the linchpin for a regime of enhanced cross-border legal certainty in the present context. Therefore, a harmonised protection rule is of utmost importance and only a high degree of uniformity can significantly eliminate the threat of unexpected reversal of book entries. For this reason, a common framework would need to be based on a purely

functional provision without allusions to traditional legal concepts and employ neutral terminology in order to avoid misinterpretation.

8.3 Questions

Q16: Do you agree with the 'test of innocence' as proposed ('knew or ought to have known') ? Do you know of any practical obstacle that could flow from its application in your jurisdiction? What would be the negative consequences in that case?

9 – Priority

9.1 Principle

1. The national law should provide that Priority rules prescribe that

   (a) interests in the same account-held securities which are acquired by earmarking rank amongst themselves in chronological order;

   (b) interests in the same account-held securities which are acquired by control agreement or an agreement with and in favour of the account provider rank amongst themselves in chronological order;

   (c) interests in account-held securities which are acquired by earmarking have priority over interests acquired in the same account-held securities by means of a control agreement or an agreement with and in favour of the account provider.

2. An acquisition of securities, account-held securities or interests therein effected under Articles 5 should prevail over any other method permitted by the national law.

3. Parties should be able to deviate from the above rules by agreement. Such agreement cannot affect the rights of third parties.

4. Security interests or other limited interests created by mandatory operation of the applicable law should have the priority attributed by that law.

9.2 Background

As a further issue, harmonisation at EU-level of rules on priority of interests appears to be necessary. "Interests" is a generic term to designate the legal position conferred by a book entry, whether it is a right of ownership as defined under the applicable law or whether it is a security interest such as the one provided through a collateral arrangement.

Priority conflicts between several market participants with respect to the same account-held securities can, and do in practice, arise. The national laws this question in different manners. Future harmonised legislation would need to provide appropriate rules, striking a balance between the various methods for acquiring securities and interests therein on the basis of the following criteria: first, the chronological order in which competing rights or interests are established, second, the different nature of the methods used, third, an agreement by the parties to alter the order of priority, and, fourth, policy decisions that give absolute protection of certain claims.

The chronological order is a classical means of determining an order of priority with respect to rights and interests created in the same assets. Generally, rights and interests created earlier in time prevail over others created subsequently.

A more difficult issue is whether interests created by means of specific methods should have a "better" priority although they have been established later in time as compared to other interests created with respect to the same securities but by different methods. There is large support for the view that book-entries to an account should have constitutive effect as regards acquisition and disposition of securities and that the use of book-entries generally increases transparency. Against this background, interests created by book-entries should be attributed a priority rank that is more favourable than the priority rank granted to interests created under non-account-held methods. This idea, however, can logically only apply to earmarking, as crediting and debiting are not within the scope of the priority provisions.

The principle of contractual freedom of the parties allows for the order of priority to be changed by them. However, such agreement may not affect the rights of third parties. On the basis of policy decisions, national law often attributes a certain rank to certain claims (for example the tax or social security authorities might have a super-priority over the assets of a debtor). The envisaged Principle is not intended to change priority or rank which is attributed to a non-consensual interest.

9.3 Questions

Q17: Will a principle along the lines set out above, under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not 'visible' in the relevant securities account? If not, please explain why.

Q18: Have you encountered difficulties regarding the priority/rank of an interest created under a mechanism comparable to a control agreement in the context of a priority contest, or, more generally, in an insolvency proceeding? If yes, please specify.

Q19: Would there be negative practical consequences for your business model flowing from a Principle along the lines set out above? If yes, please specify.

10 – Protection of account holders in case of insolvency of account provider

10.1 Principle

1. The national law should ensure that In the event of insolvency of the account provider securities and account-held securities held by the account provider for its account holders should be unavailable for distribution among or realisation for the benefit of creditors of the account provider.

2. The national law applicable in the insolvency of an account provider should provide for a mechanism governing the distribution of the shortage in the event of an insufficient number of securities or account-held securities in the sense of Principle 4 paragraph 2 being held by an insolvent account provider.

10.2 Background

It is impossible to exclude operational failure hundred per cent. An account provider might, intentionally or accidentally, credit more securities to its clients' accounts than it holds itself, and fail to apply the remedies of reversal and buy-in properly and timely. This risk is particularly high in pre-insolvency situation. Therefore, there needs to be a rule stating the consequences of a shortage of securities in the event of insolvency of the account provider (*cf.* Section 4 above) is the insolvency of the account provider. The national law should provide for a mandatory mechanism that eliminates the imbalance between the aggregate number of securities credited to accounts and the number of securities issued, in order to protect issuers and prevent systemic instability by clearly and immediately answering the question who owns what.

Some commentators proposed that in case the account provider holds securities for its own account, these securities should be attributed to its account holders. However, such a principle would result in granting an unjustified super-priority to securities account holders, over any other types of creditors of an insolvent account provider, including other clients.

Similarly, any funds still available in the insolvent estate cannot be used, in analogy to the Principle contained under Section (paragraph 2.a), to buy in missing securities. Consequently, as there is no possibility left to *increase* the number of securities held by the insolvent account provider for its account holders, the only possible solution is to *diminish* the number of securities credited to the accounts of the account provider's clients. For reasons of account holder protection and stability of the system, any arbitrary allocation of the loss to one or the other account holder should be avoided. Originally, there seemed to be support for a harmonised rule on how a potential shortfall should be shared, which provided for a *pro rata* sharing of the holdings ('mandatory mutualisation of the loss'). The background for this proposal was first, that it would be very difficult to argue for the loss to be born by individual account holders. Even in the event where it is possible to identify one or more account providers that are "closer" to the facts that actually caused the loss (for example: those account holders that received credits on their accounts at the time the loss occurred) they would become victim of the account provider's mistake or misbehaviour in a rather arbitrary manner. Second, individualisation of losses would generally bear the risk of producing further failures, notably of those affected by the individualised loss, with the potential of a chain reaction of insolvencies.

Nevertheless, a harmonised loss sharing rule at EU-level would impinge on rules of national insolvency law addressing the issue and potentially distort prioritisation of account holders' and security providers' interests. Therefore, the envisaged principle only proposes that the national law should contain a clear and predictable solution, leaving the details and mechanisms of such solution should to national policy.

10.3 Questions

Q20: Would a Principle along the lines described above pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?

Q21: If not: Which mechanisms should be available which could not be implemented under a framework designed along the lines described above. Please specify.

Q22 Should the sharing of a loss in securities holdings (occurring, for example, as a consequence of fraud by the account provider) be left to national law ? Would you prefer a harmonised rule, following the *pro rata* principle or any other mechanism?

11 – Instructions

11.1 Principle

1. An intermediary should neither be bound nor entitled to give effect to any instruction in relation to account-held securities of an account holder given by any person other than that account holder.

2. Paragraph 1 is subject to:

(a) any agreement between account holder and account provider;

(b) the rights of any person, including the intermediary, who has acquired an interest in the relevant account-held securities;

(c) any judgement, award, order or decision of a court or other judicial or administrative authority of competent jurisdiction;

(d) any rule of the applicable law;

(e) if the account provider is the operator of a securities settlement system, the rules of that system, to the extent permitted by the law governing the system.

11.2 Background

As crediting, debiting and earmarking are capable of immediately affecting market participants' legal positions towards account-held securities, the envisaged legislation must make sure that the account provider follows only the instruction of the account holder.

However, there are various well reasoned exceptions: in particular, the account provider and the account holder could contractually agree on another person being authorised to give instructions, for example in case of a family member being mandated to make any disposition; or, the national law might provide for the power to instruct the account provider in the context of tutelage or similar. Additionally, the right to instruct might also depend on whether a security interest over the relevant account-held securities had been established, and similar cases.

11.3 Questions

Q23: Would a Principle along the lines described above provide for a framework allowing the national law to effectively apply restrictions on whose instructions to follow for purposes of investor protection, notably in connection with the envisaged Principle contained under section 4 (Paragraph 2)? If not, please explain why.

12 – Attachment by creditors of the account holder

12.1 Principle

The national law should provide that Creditors of an account holder may attach account-held securities only at the level of the account provider of that account holder.

12.2 Background

There are two scenarios which need special attention when it comes to attaching account-held securities, as opposed to attaching other interest or chattel: on one hand the prohibition of 'upper-tier attachment' (present section 12), and, on the other hand, the attachment of segregated client accounts (see below section 13). Whilst both mechanisms relate to “attachments” they deal in fact with two different issues.

The term "Prohibition of upper-tier attachment" is commonly used to refer to the risk that a securities account with an account provider at a higher tier in the holding pattern may be subject to a legal claim (typically through court proceedings) to freeze or attach the account in order to enforce a claim against a person alleged to hold an interest through an account provider at a lower tier. This phenomenon occurs in the following forms:

In holding arrangements where legal relationships exist only between the account holder and it's own direct account provider the account holder has no rights against any higher-tier account provider. Hence, there is nothing to attach at the higher-tier account provider level. The taking up of an “upper-tier prohibition rule” in such a legal context is thus merely stating the obvious and serves as a clarification.

In holding arrangements where the investor is considered to be the direct owner of the securities all the way down the holding chain, upper-tier attachment is conceivable. Two scenarios must be distinguished:

First, the investor, as legal owner of the securities, can only be identified as such by his own direct account provider, the higher-tier account provider being unable to do so; in this case higher-tier identification is not possible. Consequently, the upper-tier prohibition rule is important and adds actual legal value.

Second, the investor, as legal owner of the securities is identified or identifiable at the direct *and* at the higher-tier account provider level; in this case, higher-tier identification is possible and a legal and a policy issue arise. The following key elements are of importance: (i) where the investor has a direct account relationship with the higher-tier account provider, its direct account provider acting merely as an “account operator”, there is no issue of upper-tier attachment because there is only one securities account (maintained by the upper-tier entity and administered by the account operator; (ii) where the direct account provider of the account holder holds itself an account with a higher-tier account provider which is subdivided in as many sub accounts as there are direct investors and the identity of the investors is disclosed to the higher tier account provider one may conceive an “upper-tier attachment”. This depends, however, in particular on, first, the identification of the decisive record (direct account provider/higher-tier account provider) of the investor’s rights, and, second, a solid information transfer system between the direct and the higher tier account provider to ensure that they receive the same information in real time.

12.3 Questions

Q24: Would a Principle along the lines described above provide Member States with a framework allowing them, in combination with the envisaged Principle on shared functions, to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.

Q25: Have you ever encountered, in your business practice, attempts to attach securities at a tier of the holding chain which did not maintain the decisive record? If yes, please specify.

13 – Attachment by creditors of the account provider

13.1 Principle

The national law should prohibit that creditors of an account provider attach securities credited to accounts opened in the name of that account provider with a second account provider, as far as these accounts are identified as containing securities belonging to the first account provider's customers. Where the law provides for a presumption that accounts opened by an account provider with a second account provider contain securities belonging to customers, the presumption should apply.

13.2 Background

The goal of a rule on prohibition of the attachment of segregated client accounts by creditors of the account provider is to enhance investor protection and to allow for an efficient functioning of holding through securities accounts in structures using multiple tiers and omnibus accounts.

Articles 13(7) and 13(8) of MiFID and Article 16(1)(d) of the MiFID Implementing Directive already require that credit institutions and investment firms "must take the necessary steps to ensure that any client financial instruments deposited with a third party (…) are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection". This segregation rule is designed to safeguard client securities in case of insolvency of the account provider and to prevent the use by the account provider of client securities for own account.

In the context of this initiative aimed at harmonizing the framework for securities holding and dispositions, it is appropriate to regulate specifically the situation and rights of account providers' creditors. Therefore, the idea is to provide that those creditors may not attach accounts which are identified as 'client accounts' with a higher-tier account provider.

It is worth noting that in some countries there is a rebuttable presumption that an account that an account provider has with an upper-tier account provider *always* contains clients' assets, which is probably the strongest protection possible. Such national rule should be maintained and respected.

13.3 Questions

Q26: Would the proposed framework for protecting client accounts be sufficient? Should the presumption that accounts opened by an account provider with another intermediary generally contain client securities become a general rule? If not, please explain why.

14 – Determination of the applicable law

14.1 Principle

1. The national law should provide that any question with respect to any of the matters specified in paragraph 3 arising in relation to account-held securities should be governed by the national law of the country where the relevant securities account is maintained by the account provider. Where an account provider has branches located in jurisdictions different from the head offices' jurisdiction, the account is maintained by the branch which handles the relationship with the account holder in relation to the securities account, otherwise by the head office.

2. An account provider is responsible for communicating in writing to the account holder whether the head office or a branch and, if applicable, which branch, handles the relationship with the account holder. The communication itself does not alter the determination of the applicable law under paragraph 1. The communication should be standardised.

3. The matters referred to in paragraph 1 are:

(a) the legal nature of account-held securities;

(b) the legal nature and the requirements of an acquisition or disposition of account-held securities as well as its effects between the parties and against third parties;

(c) whether a disposition of account-held securities extends to entitlements to dividends or other distributions, or redemption, sale or other proceeds;

(d) the effectiveness of an acquisition or disposition and whether it can be invalidated, reversed or otherwise be undone;

(e) whether a person's interest in account-held securities extinguishes or has priority over another person's interest;

(f) the duties, if any, of an account provider to a person other than the account holder who asserts in competition with the account holder or another person an interest in account-held securities;

(f) the requirements, if any, for the realisation of an interest in account-held securities.

4. Paragraph 1 determines the applicable law regardless of the legal nature of the rights conferred upon the account holder upon crediting of account-held securities to his securities account.

14.2 Background

Many dispositions in securities involve a cross-border element. Therefore, more than one jurisdiction may be relevant to these dispositions. As already mentioned, not only the legal concepts applying to securities held through account providers vary considerably, but similarly the conflict-of-laws rules do not conform to each other. Three directives address the issue, amongst other questions, notably Article 9(1) of the Financial Collateral Directive, Article 9(2) of the Settlement Finality Directive, and Article 24 of the Winding-Up Directive.

The *status quo* raises three questions: First, the conflict-of-laws rules as contained in the three directives are based on slightly different criteria. The envisaged legislation should bring the three rules in line with each other so as to ensure consistency and predictability.

Second, these rules exclusively apply to the relatively limited scope of the directives, notably to those organisations covered by their personal scope. The envisaged legislation should apply to all account holders and account providers. Consequently, a uniform conflict-of-laws rule for all market participants would be useful.

Third, taking Article 9(1) of the Financial Collateral Directive, which is the most recent one, as a conceptual starting point, it becomes clear that that in some (admittedly rare) cases the interpretation of where securities accounts are "located" could diverge. That means, before settling on a uniform conflict-of-laws rule for the entire environment, the rule itself needed to be clarified as regards the so called "connecting factor.

The connecting factor of the conflict-of-laws rule should be based on the factual criterion similar to the criterion used in the three directives, i.e. where a securities account is 'maintained'. However, more guidance is needed for proper interpretation of this criterion, in particular as regards multi-branch entities. In this respect, regard has to be given to the reasonable perspective of the account holder, which expects that the national law of the country is applicable where the branch is located which handles the relationship with the account holder in relation to the securities account. In deciding which branch is servicing the client, the question of through which branch the account was opened, which branch handles the commercial relationship with the account holder, and which branch administers payments or corporate actions relating to the securities credited to the securities account, and similar aspects, will have to be taken into account, whereas the place of the location of supporting technology or of call or mailing centres should be disregarded. However, these additional guidelines as to which branch handles the relationship should not figure as cumulative elements of the connecting factor but rather as clarifying elements of interpretation figuring in the recitals of the instrument (*cf.* paragraph 1 of the envisaged Principle).

In addition to clarifying the connecting factor itself improvement of *ex-ante* legal certainty is necessary. As the connecting factor is fact-based and subject to legal interpretation, ultimately confined to the judge, it is basically a criterion delivering an *ex post* view. However, increased legal certainty requires active reliable *ex ante* knowledge of the applicable law. Paragraph 2 of the envisaged Principle cuts the Gordian knot by prescribing a practical solution, allowing for a fact based connecting factor while at the same time increasing *ex ante* predictability: account provider should always be in a position to tell where an account is maintained, i.e. which branch handles the client relationship. This certainty should be transferred to the account holder by communicating the relevant location. The account provider should be responsible for the correct fulfilment of this duty and the competent authority should be in a position to intervene where the communication does not reflect the location where the account is actually

serviced. However, there needs to be a clarification that the approach remains entirely fact based and that the communication must not be able to alter the underlying analysis of where the account is actually maintained. A judge will have to look at the facts, not at the communication, in order to determine the applicable law. In case the factual analysis and the communication differ, the factual analysis prevails and the account provider will be responsible for any incorrect communication in this regard (cf. Paragraph 2 of the envisaged Principle).

There is agreement that a conflict-of-laws rule should roughly cover what is dealt with in the substantive law part regarding holding and disposition of account-held securities. However, there are additional elements which need to be covered by the conflict of laws rule, notably those that are closely connected to the matter but are, in the substantive law part, left to autonomous national legislation. For instance, the characterisation of the legal nature of the rights arising from crediting securities accounts would need to be included. Furthermore, there are aspects addressed in the substantive part which should not be governed by the conflict-of-laws rule, for instance the loss sharing mechanism in case of insolvency. Consequently, a detailed list of issues setting out the scope of the conflict-of-laws rule needs to be included in a separate paragraph, (*cf.* paragraph 4 of the envisaged Principle).

There needs to be a clarification that all securities credited to a securities account are covered by the conflict-of-laws rule, regardless the legal nature that national law attributes to them. This aspect is particularly important where national law characterises certain account-held securities in a cross-border context as being of contractual or similar nature (*cf.* paragraph 5 of the envisaged Principle).

There might be additional benefit in harmonising the way by which the location is communicated to the account holder, for example in a separate document, on the account statement, or even as part of the account number. This rather technical issue would benefit from some degree of standardisation.

14.3 Questions

Q27: Would a Principle along the lines described above allow for a consistent conflict-of-laws regime? If not: Which part of the proposal causes practical difficulties that could be addressed better?

Q28: Would the mechanism of communicating to the client, whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to *ex-ante* clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?

Q29: The Hague Securities Convention (www.hcch.net/index_en.php?act=conventions.text&cid=72) provides for a global harmonised instrument regarding the conflict-of-law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed principle 14 differ from the Convention as regards the basic legal mechanism for the identification of the applicable law. However, the scope of principle 14 is the same than the scope of the Convention: property law, collateral, effectiveness, priority. Do you

agree that this will facilitate the resolution of conflicts with third country jurisdictions ? If not, please explain why.

15 – Cross-border recognition of rights attached to securities

15.1 Principle

1. the national law governing a securities issue as well as the national law governing the holding of securities should not discriminate against the exercise of rights attached to securities held in another jurisdiction on the sole grounds that the relevant securities are held in a specific manner, in particular

- through one or more account providers,
- through an account provider acting in its own name but for the account of its account holders,
- through accounts in which securities of two or more account holders are held in an indistinguishable manner.

2. The national law should remain free to prescribe which holding methods account providers should offer to their account holders.

15.2 Background:

The national law is often tailored to match domestic holding patterns and might in certain cases not correctly mirror securities holdings in other jurisdictions thus making the exercise of rights attached to the relevant securities cumbersome or impossible. It is therefore appropriate to require national law not to discriminate the exercise of rights attached to securities on the sole grounds that they are held under a holding pattern which differs from the holding pattern in the issuer's jurisdiction, as for instance the holding through more than one account providers in general, or through so called nominee or omnibus accounts which might exist in a number of jurisdictions.

Articles 13(4), (5) and 10(1), (3) of the Shareholders' Rights Directive address this issue regarding voting rights and general meetings in respect of publicly traded shares, but not in relation to *other* types of securities (in particular bonds) or other types of rights attached to securities, as for instance the acceptance of a takeover-bid or the exercise of a subscription or exchange right. Therefore, the envisaged Principle would generalise the mutual recognition of holding patterns to all types of securities.

15.3 Questions

Q30: Would a general non-discrimination rule along the lines set out above be useful? Have you encountered problems regarding the cross-border exercise of rights attached to securities?

Q31: If applicable, would a Principle along these lines have (positive or negative) repercussions on your business model? Please specify.

16 – Passing on information

16.1 Principle

1. The national law should require that Information with respect to securities received by an account holder, which is not the ultimate account holder, from its account provider or from the issuer should be passed on to its account holder or, if possible, to the ultimate account holder without undue delay as far as information

(a) is necessary in order to exercise a right attached to the securities which exists against the issuer; and

(b) is directed to all legal holders of securities of that description.

2. The account provider of the ultimate account holder must pass on information with respect to the exercise of rights attached to securities received from the ultimate account holder to the issuer of the securities or, if applicable, the following account provider without undue delay, as far as information is provided by the ultimate account holder in the course of the exercise of a right attached to the securities.

16.2 Background

Account providers, as the central element of modern securities holding and settlement, have to ensure a harmonised level of basic assistance to investors as regards the exercise of rights enshrined in securities. The first level of basic assistance, which concerns all account providers of a holding chain concerns obligation to pass on information relating to the exercise of rights attached to the securities.

Information and messages regarding the exercise of corporate rights released by the issuer need to reach the ultimate account provider in order to enable it to determine the exercise of and receive the rights attached to securities. Equally, information and messages directed by the ultimate account holder towards the issuer need to reach the latter in order to achieve that objective. All financial intermediaries acting as account providers in a holding chain should be obliged to pass on to the following link in that holding chain the information which they receive in that capacity.

Since the flow of information and messages potentially available upstream and downstream might be considerable, and considering that financial intermediaries in their role as account provider incur cost for processing it, it is appropriate to limit the flow of information and messages to the necessary.

As the information available on the side of the issuer might be vast in terms of content and possible sources, the necessary should consist of information and messages stemming from the issuer itself, as opposed to those stemming from third parties, which are being processed through the holding chain and which are necessary for the exercise of rights while at the same time being directed to all legal holders of the relevant class of securities, as opposed of being directed to individual ones. The term 'necessary' refers to information and messages which are *conditio sine qua non* for the exercise of rights attached to securities. For the obligation to process it is irrelevant whether information is also publicly available. The right and corresponding duty is without any prejudice to obligations of the issuer flowing from company law (transparency, etc.).

Information and messages stemming from the ultimate account provider should be processed only if they relate to the exercise of or the receipt of a right attached to the relevant securities.

Since the cost incurred by financial intermediaries for processing information and messages upstream and downstream will vary considerably depending on the number of financial intermediaries involved, the type of information or message, the degree of standardisation and the complexity of holding arrangements and since a regulation of the repartition of this burden amongst issuers, financial intermediaries and ultimate account holders would probably carve in stone current market complexity it is appropriate to leave the sharing of the financial burden to the market itself and control of the cost to open competition.

The duty to pass on information and messages as such should not be subject to a contractual opt-out as information should be processed to the extent to which ultimate account holders are entitled to determine the exercise of the rights. In other words, the extent of information to be processed is directly accessory to the range of rights the exercise of which can be determined by the ultimate account holder. Consequently, to the extent ultimate account holder opt out from the right to determine the exercise of and receive certain rights attached to securities (*cf. infra)*, information and messages relating to relevant rights would not need to be processed. A separate opt-out provision in respect of the duty to process information and messages is therefore not appropriate.

Standardisation plays a primordial role for the development of cross-border investment. Given that the consistent and timely processing of information heavily depends on the standardisation of operational procedures and key dates used by issuers and financial intermediaries, the Commission strongly encourages market led standardisation in this field. In order to streamline existing standardisation practices, future legislation may foresee a mechanism that would facilitate and monitor market-led standardisation and install a regulatory option should market-led standardisation fail.

16.3 Questions

Q32: Is the duty to pass on information adequately kept to the necessary minimum? Is it sufficient?: If applicable, would there be any (positive or negative) repercussion of such a Principle on your business model? Please specify.

Q33: How do you see the role of market-led standardisation regarding the passing on of information? What are your views on a regulatory mechanism for streamlining standardisation procedures?

17 – Facilitation of the ultimate account holder's position

17.1 Principle

1. The national law should require that the account provider of the ultimate account holder should be bound to facilitate the determination of the exercise of rights attached to securities by the ultimate account holder against the issuer or a third party as requested by the ultimate account holder.

2. Such facilitation must at least consist in the account provider of the ultimate account holder

(a) arranging for the ultimate account holder or a third person nominated by the ultimate account holder being the representative of the legal holder with respect to the exercise of the relevant rights, if the account provider or a third person is the legal holder of securities, in which case Article 11 of the Shareholders' Rights Directive applies correspondingly; or,

(b) exercising the rights attached to the securities upon authorisation and instruction and for the benefit of the ultimate account holder, if the account provider or a third person is the legal holder of the securities; or,

(c) providing the ultimate account holder, regardless of whether it is the legal holder of the securities or not, with evidence confirming its holdings and it being enabled to exercise the rights attached to the securities against the issuer or a third party, under a general framework guaranteeing the integrity of the number of available rights and the position of the legal holder of the securities in respect of lit. (c) of paragraph 2. The content and form of the evidence to be provided should be specified and standard forms should be developed, in particular to define under which conditions issuers should recognise such evidence for purposes of exercising rights attached to securities.

3. The extent to which the obligations following paragraphs 1 and 2 can be made subject to a contractual agreement between the ultimate account holder and its account provider as well as the formal requirements to be met by such agreement should be subject to restrictions for purposes of client protection.

17.2 Background

Any mechanism actually enabling the ultimate account holder to determine the exercise of and receive the rights attached to securities needs to recognise the position of the legal holder of the relevant securities (shareholder, bondholder) as determined by the national law governing the securities issue. Thus, the position of an ultimate account holder which is not the legal holder in the context of exercising and receiving rights attached to securities can only be a position derived from the legal holder's position.

The first classical means of enabling the ultimate account holder to determine the exercise of or receive the rights attached to securities is making it the legal representative of the legal holder for the purpose of exercising and receiving the rights. The envisaged legislation should take into account that the ultimate account holder might wish to have a third person determining the exercise of the rights, in particular where the securities are credited to the ultimate account holders securities account under a security interest while the security arrangement, in accordance with the applicable law, provides for the rights still to be attributed to the grantor of the security interest (*cf.* also Section 3, paragraph 3 of the envisaged Principle).

The second classical means is for the ultimate account holder to direct and authorise the exercise and receipt of rights attached to securities by the legal holder by being entitled to give instructions to it.

It is therefore appropriate to require the availability and recognition of these two methods under all Member States' law and confer on ultimate account holders which are not legal

holders themselves a right to be made representative, or to be able to direct and authorise the exercise respectively.

The two described methods build on the correct identification of the legal holder of securities, as the position of the ultimate account holder is to be derived from the legal position of the former. However, in a cross-border context, the identification might be difficult and cumbersome, in particular in the scenario of multi-level holding chains crossing three or more jurisdictions and there might be uncertainty whether the ultimate account holder itself is legal holder or whether it is not. The ultimate account holder's right to become representative or to give instructions under the methods described above can only materialise if the link to the legal holder can be traced timely and reliably. It appears therefore appropriate to include a third method which evidences the position of the ultimate account holder *vis-à-vis* the issuer. In order to respect the rights of legal holders and to avoid uncertainty regarding a potential simultaneous exercise of the relevant rights by both the legal holder and the ultimate account holder at the same time it is necessary that such method is built as a closed system with the issuer providing the root for the evidence to be distributed amongst ultimate account holders. No such system exists on a universal basis and technical standards as for instance regarding bar-codes as evidence entitling to voting or internet-based participation would need to be developed.

It is important that the addressee of the ultimate account holder's right to be made a representative, to direct and authorise the exercise or to receive appropriate evidence defined. Since the ultimate account holder has access to the holding chain only through its own account provider, it should be up to this account provider to arrange for the ultimate account holder's right to be put in practice. This account provider maintains the securities for the ultimate account holder and should consequently ensure that it is legally and operationally in a position to satisfy the ultimate account holder's right to determine the exercise of and receive the rights attached to the securities under one of the three alternative methods. To this end, it must make appropriate arrangements with the remaining links of the holding chain. Market standards regarding the operational aspects of processing rights attached to securities timely and reliably through the holding chain should make possible and support such arrangements.

Following general principles this area is subject to contractual party autonomy. However, it should be made sure that dominant negotiating power of account providers *vis-à-vis* ultimate account holders, in particular retail investors, does not lead to a situation where cost structures effectively preclude the exercise of rights. It is therefore appropriate to address these aspects in some detail The various types of rights attached to securities should be taken into account. Allowing an opt-out from processing material rights (like dividend and interest payments) would only make sense in very limited cases, whereas there might be more room for contractual opt-out from participatory rights (like voting).

17.3 Questions

Q34: If you are an investor, do you think that a Principle along the lines described would make easier any cross-border exercise of rights attached to securities, provided that technical standardisation progresses simultaneously? If not, please explain why.

Q35: If you are an account provider, would you tend towards the opinion that your clients can exercise the rights attached to their cross-border holdings as efficiently as their domestic holdings? What would be the technical difficulties you would face in

implementing mechanisms allowing for the fulfilment of the duties outlined above? What would be the cost involved?

18 – Non-discriminatory charges

18.1 Principle

The national law should ensure that Charges levied by an account provider on its account holders for any service relating to the compliance with any of the duties established in Principles 16 and 17 in respect of cross-border holdings of securities should be the same as the charges levied by that account provider on its account holders in respect of comparable domestic holdings of securities.

18.2 Background

The implementation of Principles 16 and 17 may cause an increase of costs born by account providers, especially as concerns the costs related to crossborder holdings. The first public consultation on the securities law legislation held in 2009 reported a tendency for account providers to elevate fees or reduce the level of services concerning the passing up and down of information and the processing of corresponding rights.

Generally, such costs related to the processing of rights are shared on a contractual basis between account providers and issuers on the one hand, and between account providers and account holders on the other hand. But the creation by virtue of law of additional costs related to crossborder transactions bypasses ordinary contractual arrangements and should therefore be accompanied by provisions organising their fair allocation.

Therefore, the Commission services consider an alternative solution consisting, instead of a direct regulation of the allocation of costs, in the setting of a general principle governing the level of costs incurred by crossborder holding. As a matter of fact, since the major mandate of the contemplated securities law legislation is to ensure an efficient single market where crossborder holdings are as safe as domestic holdings, a parallel rule regarding costs should ensure that fees incurred by crossborder holdings of securities are the same fees charged for domestic holdings. A similar approach was followed in the payment area, where regulation 2560/2001 and regulation 924/2009 set a rule granting that fees charged for crossborder transfers of cash should not be higher than fees charged for domestic transfers of cash.

As a consequence and with a view to promoting investment throughout the entire EU and to protecting investors holding portfolios of securities from more than one EU jurisdiction, it is appropriate to prevent discrimination of cross-border holdings as opposed to purely domestic holdings in terms of cost structures. The principle above is inspired by Article 3 of Regulation 924/2009, especially the concept of "corresponding national holding" referring to correspondences between domestic and national holdings, by class of assets or by description of securities. Contrary to Article 3 of Regulation 924/2009, it might not be necessary to set a threshold since the first consultation of 2009 has shown that the risk of discrimination due to a crossborder context concerns large holdings as well as small holdings.

18.3 Questions

Q36: If you are account holder, have you encountered differing prices for the domestic and the cross-border exercise of rights attached to securities? If yes, please specify.

Q37: If you are an account provider: do you price cross-border exercise of rights differently from domestic exercise? If yes: on what grounds are different pricing models necessary?

19 – Holding in and through third countries

19.1 Principle

An account provider should make reasonable and appropriate arrangements with its account holder if the account holder maintains account-held securities for others and is not subject to the rules of this Directive, facilitating the effective exercise of rights attached to the securities which the account holder holds for others. Technical standards to be adopted by the Commission on this issue could be envisaged.

19.2 Background

As a considerable part of cross-jurisdictional holding situations involves third-country account providers, there needs to be a rule promoting the principles described above in exactly such a context. This is all the more important as sometimes holding chains "exit and re-enter" the EU, i.e. in cases in which one of the account providers involved is located in a third country but its account holders are, again, located within the EU. The application of the proposed provisions themselves will be naturally confined to EU-regulated entities. Therefore, any mechanism promoting the principles in a third-country context must in the first place connect to an EU-regulated entity that is the last entity before the holding chain 'exits' the EU. This entity has to comply with the envisaged legislation, also in relation to its third-country account holder. If this non-EU account holder is itself an account provider for a third party, the duties of the envisaged legislation cannot apply to this latter relationship. Therefore, an EU-initiative will be unable to *guarantee* the effective exercise of rights by clients of a non-EU account provider. In order to *promote the improvement* the effective exercise of rights in such cases, it is appropriate to introduce an extended duty of the EU regulated account provider which serves the non-EU account provider.

19.3 Questions

Q38: Have you encountered difficulties in using non-EU linkages as regards the exercise of rights attached to securities? If yes, please specify. If not, please explain why.

Q39: Admitting that non-EU account providers cannot be reached by the planned legislation, which steps could be undertaken on the side of EU account providers involved in the holding in order to improve the exercise of rights attached to securities through a holding chain involving non-EU account providers?

20 – Exercise by account provider on the basis of contract

20.1 Principle

Where an ultimate account holder is able to exercise itself the rights flowing from securities but does not want to do so, its account provider exercises these rights upon its

authorisation and instruction and in accordance with the contractually agreed level of services. There should be an EU-wide standard regarding the formal requirements to be met by such an agreement as far as it provides for general authorisation of the account provider to exercise the rights flowing from the securities.

20.2 Background

Where an ultimate account holder could exercise the rights attached to securities itself because it is at the same time legal holder of the securities but does not want to so, the account provider should be obliged to exercise on his behalf only within the framework of the level of service contractually agreed between both parties. Since this principle bears the risk that ultimate account holders transfer the right to receive and exercise the rights in too extensive a manner, again against the background of bargaining power and cost structures, detailed rules could define the limits of such transfer, in particular the formal requirements to be met by a general and permanent transfer of the right to exercise and receive the rights attached to the securities.

20.3 Questions

Q40: Do you think that a general authorisation to exercise and receive rights given by the account holder to the account provider should be made subject to certain formal requirements? Please specify.

21 – Account provider status

21.1 Principle

All securities account providers should be regulated on a European level. To this end, ‘safekeeping of securities [etc.]’, Annex I Section B (1) of the MiFID, should be upgraded to become an investment service (under Section A(9) of Annex I) and those which provide this service should be authorised and supervised under MiFID.

22.2 Background

All jurisdictions aim at increasing the safety and soundness of holding through account providers as these entities are in a position to play a central role in the safeguarding of the integrity of a securities issue and the protection of investor's holdings. Therefore, account provider's activity is regularly put under the scrutiny of a competent authority. Providing the service of maintaining securities accounts is an "ancillary service under Annex I Section B of the MIFID. The provision of ancillary services per se does not require an authorisation. However, if provided by an investment firm, the rules of the MIFID apply (cf. Articles 5(1) and 6(1) of the MIFID). This means that if an account provider is not an investment firm in the sense of MIFID, its activity, though being an ancillary service, is not subject to the rules of the current possible legislative initiative. Hence, at the level of the EU, there is a regulatory "gap" as there is no common rule on the question of whether or not such entities have to be subject to authorisation and regulation which might be filled by upcoming harmonised legislation.

21.3 Questions

Q41: Should the status of account provider be subject to a specific authorisation? If not, please explain why.

Q42: If yes, do you think that MIFID would be an appropriate instrument to cover the authorisation and supervision of account providers?

22 – Glossary

(a) 22.1 Principles'securities' means financial instruments as listed in Annex I Section C of Directive 2004/39/EC, which are capable of being credited to a securities account;

(b) 'securities account' means an account between an account provider and an account holder allowing for the evidencing of securities holdings of that account holder with that account provider;

(c) 'account provider' means a person who:

– maintains securities accounts for account holders and is authorised in accordance with Article 5 of Directive 2004/39/EC to provide services listed in Annex I Section A indent (9) of Directive 2004/39/EC or is a Central Securities Depository as defined in […] and, in either case, is acting in that capacity;

– *[in relation to Principles 3 to 13, if not subject to a national law, in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;]*

(d) 'account holder' means a person for whom an account provider maintains a securities account, whether that person is acting for its own account or for others, including in the capacity of account provider;

(e) 'ultimate account holder' means an account holder which is not acting in the capacity of account provider for another person;

(f) 'legal holder' means the shareholder, bondholder or holder of other financial instruments, as defined by the national law under which the relevant securities are constituted;

(g) 'insolvency proceeding' means any winding-up proceeding or reorganisation measure as defined in Article 2 (1)(j) and (k) of Directive 2002/47/EC;

(h) 'insolvency administrator means any person or body appointed by the administrative or judicial authorities whose task is to administer an insolvency proceeding;

(i) 'securities of the same description' means securities issued by the same issuer and being of the same class of shares or stock; or in the case of securities other than shares or stock, being of the same currency and denomination and treated as forming part of the same issue;

(j) 'securities settlement system' means a system as defined in Article 2(a) of Directive 98/26/EC for the processing of transfer orders referred to under the second indent of Article 2(i) of Directive 98/26/EC;

(k) 'acquisition' means the receiving of account-held securities or of a security interest or other limited interest therein;

(l) 'disposition' means

- to relinquish account-held securities (disposal), in particular for the purpose of a sale,
- to create security interests or other limited interests in account-held securities in favour of another person, or
- to relinquish security interests or other limited interests in account-held securities.

(m) 'reversal' means that a crediting, debiting, earmarking or removal of an earmarking is undone by a converse act;

(n) 'crediting' means the adding of account-held securities to a securities account;

(o) 'debiting' means the subtracting of account-held securities from a securities account;

(p) 'earmarking' means an entry in a securities account made in favour of a person, including the account provider, other than the account holder in relation to account-held securities, which, under the account agreement, a control agreement, the rules of a securities settlement system or the applicable law, has either or both of the following effects:

- that the account provider is not permitted to comply with any instructions given by the account holder in relation to the account-held securities as to which the entry is made without the consent of that person;
- that the relevant intermediary is obliged to comply with any instructions given by that person in relation to the account-held securities as to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement or the rules of a securities settlement system, without any further consent of the account holder;

(q) 'control agreement' means an agreement in relation to account-held securities between an account holder, the account provider and another person or, if so provided by the applicable law, between an account holder and the account provider or between an account holder and another person of which the account provider receives notice, which includes either or both of the following provisions:

– that the account provider is not permitted to comply with any instructions given by the account holder in relation to the account-held securities to which the agreement relates without the consent of that other person;

– that the account provider is obliged to comply with any instructions given by that other person in relation to the account-held securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the account holder;

(r) 'attachment of account-held securities of an account holder' means any judicial, administrative or other act or process to freeze, restrict or impound account-held securities of that account holder in order to enforce or satisfy a judgment, award or other judicial, arbitral, administrative or other decision or in order to ensure the availability of such account-held securities to enforce or satisfy any future judgement, award or decision.

22.2 Background

The terms contained in this glossary define the basic legal terms on which a possible legislation could be built. In the present context it is particularly important as the functional approach requires the use of neutral terms, in order to avoid confusion with traditional legal terms which might differ in detail in the various Member States' law.

For example, "control agreement" refers to methods to create for example a pledge, charge, mortgage or other security interest. "Control agreement" is used to encompass pledges, charges, etc. under national law which can be created by an arrangement where a person obtains control of the pledged asset and exercises that control to ensure the security takers right to enforce the security interest in case of default of the security provider.

The functional approach is therefore a descriptive one, helping to avoid the misunderstanding that identical words mean the same thing in different legal traditions.

On a number of defined terms more specific information is provided in the context of the material provisions presented in the previous sections

Attention of stakeholders is drawn on the definition of "Account provider", second paragraph, which seeks for global compatibility with non EU definitions, in the case of holding chains that cross EU borders. This second paragraph is at a very preliminary stage of drafting and presented only for the sake of consistency.

22.3 Questions

Q43: Do the terms used in this glossary facilitate the understanding of the further envisaged Principles ? If no, please explain why.

Q44: Would you add other definitions to this glossary ?

Specific questions can be asked to :

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