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Subject: EU Clearing and Settlement
Legal Certainty Group
Advice

1. SUMMARY

The Legal Certainty Group's mandate requires it to undertake legal analysis of three identified problems of legal uncertainty. It also requires it to propose solutions, where necessary by advising that the law should be changed. The three issues are as follows.

1.1. The absence of an EU-wide framework for the treatment of interests in securities held with an intermediary.

The Group's advice is that new legislation is needed about the legal effects of book entries made on securities accounts. This legislation should aim at minimum harmonisation of Member States' laws. The basic design for this new legislation is set out in sections 5 and 6 below.

The Group has no view about the form that the new legislation should take, in particular whether action at the Member State level, Community legislation, or an international Convention would be best.

1.2. Differences in national legal provisions affecting corporate action processing.

The mandate refers to discrepancies such as the determination of the exact moment when a purchaser is considered to be the owner of a security, e.g., for the payment of dividends.

The Group's advice is to wait until (i) specific legal issues have been exposed by the trade groups investigating the commercial aspects of this issue, under the name "Giovannini Barrier 3", within the workload of CESAME, and (ii) the final shape of the Commission's proposal for a directive on the exercise of shareholders' voting rights is known. The proposal is currently going through co-decision negotiation with the Parliament and the Council. The Group also notes that the matter may be addressed in part by the new legislation advised above.

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: C107 03/062 . Telephone: direct line (32-2) 292 13 95. Fax: (32-2) 299 30 71.

http://ec.europa.eu/internal_market/
E-mail: martin.thomas@ec.europa.eu

1.3. Restrictions relating to the issuer's ability to choose the location of its securities.

The Group's advice is that the restrictions do indeed exist, such as national legal requirements that certain securities (typically, equities) issued by companies established under that Member State's company law must be initially located within that Member State, and that new legislation would be needed to abolish them. In this advice the Group has not set out any concrete principles or design for such legislation, as the matter requires further study, not least because the market is rapidly evolving in this area.

2. BACKGROUND

The EU has been aware for many years that differences in substantive laws of Member States about the ownership of securities contribute to inefficiencies and additional costs in the market for post-trading services. These differences exacerbate fragmentation in the markets.

The existence of legal barriers to efficiency in the post-trading markets was highlighted (alongside other barriers) by the Giovannini reports of November 2001 and April 2003.

The November 2001 report identified fifteen barriers, of which many had a legal dimension and three were specifically about legal uncertainty (in netting, conflicts of law and substantive law). The April 2003 report stated that the most important legal problem was the lack of a EU wide legal framework for the treatment of ownership of securities.

The report recommended that there should be a legal framework such that, whenever securities have been entered into a book-entry system, it should be the electronic securities accounts within that system that establish ownership of those securities. There would then, it advised, be a legal identity between ownership and the record of ownership. The report also stressed the importance of removing restrictions on the issuer's ability to choose the location of its securities.

The Commission, in its 2004 Communication, acknowledged that it was necessary to analyse the need for a legal framework about holding securities with an intermediary, and established the Legal Certainty Group accordingly.

The Group was established in early 2005 and has had five plenary meetings. It also established a Legal Research Sub-Group, consisting of volunteers. The Group has surveyed the relevant laws of the 25 EU Member States, considered the laws of Japan, Switzerland and the USA, commissioned a series of research notes on specific topics, identified the seven core issues most relevant to the need for a substantive legal framework, produced detail analysis of those issues, and debated a range of possible solutions.

The bulk of the papers reflecting the Group's work, including the results of its comparative survey, are available on the Group's webpage.

Throughout its work, the Group has liaised with UNIDROIT, the Secretary of which has attended meetings as an observer. UNIDROIT is the International Institute for the

Unification of Private Law, which aims at modernising, harmonising and co-ordinating private and in particular commercial law internationally. UNIDROIT is currently developing a Convention on substantive rules regarding intermediated securities intended to improve the legal framework for holding and transfer of securities at a world-wide level.

3. APPROACH TAKEN

The Group's comparative survey confirmed that there is indeed a wide diversity among the 25 Member States as to the treatment of interests in securities held with an intermediary. The Group did not automatically assume that this of itself creates legal uncertainty, nor that any such uncertainty was a barrier to cross-border efficiency.

For that reason, it decided to explore in detail seven core issues, including within each a comparative analysis. The issues were: scope; legal effects of book entries; corporate actions and voting rights; recognition of indirect holdings; moment of transfer; transfer requirements; and priorities.

The Group found that there is legal uncertainty in the way the laws of the Member States interact with each other. In particular, the law of any one Member State cannot effectively establish what rights and duties apply to issuers governed by the law of another Member State in respect of book-entries (relating to the securities they have issued) where the book-entries are governed by the law of the first Member State. Nor, vice versa, can the law of any one Member State effectively establish what rights and duties apply to account providers governed by the law of another Member State (as against both account holders and issuers) in respect of book-entries relating to securities issued under the law of the first Member State. Further, it formed the view that the type and degree of uncertainty is in many cases a barrier to cross-border efficiency.

However, there was much debate about how best to illustrate this view. Since legal analysis cannot of itself prove economic inefficiency, and since formal economic analysis is beyond the Group's abilities, it resolved to use practical examples drawn from its wide professional expertise and legal judgement, the compilation of which is set out in an annex to this advice. Bluntly, the Group knew the legal barriers exist, but could not put a figure on the cost they represent.

Throughout its work the Group has revealed a huge range of views among its members. Unsurprisingly, the members individually have not been unanimous on many of the issues.

The Group aimed throughout its work to focus on the practical effect of rules, and not their (national) doctrinal characterisation. This corresponds broadly to the 'functional approach' advocated by the work of UNIDROIT. The Group was adamant that there should be no fundamental reconstruction of national legal systems.

As instructed, the Group identified issues that should be left to policy-makers, the most significant being what regulatory response might be triggered by the new legislation. The issues are flagged later in this advice whenever they arise.

4. PROPOSED SOLUTION

The Group resolved to advise the Commission that it should seek new legislation about the legal effects of book entries made on securities accounts. The new legislation would address all but two of the seven core issues: harmonised rules for moment of transfer and for transfer requirements would not be needed.

In reaching this view, the Group considered a range of approaches, that may be summarised into three options.

The first option was to limit the new legislation to a regime that matches the features that are already common to all Member States' regimes. This did not seem likely to result in significant benefits.

The second option was to promote new legislation that creates a substantive law regime for the legal effects of book entries, aimed to be a minimum harmonisation of Member States' laws. This was the option decided upon by the Group, as described in the rest of this advice.

The third option was to establish by the new legislation that book-entry rights are a new legal asset. This option was widely debated and found some support within the Group (as some members considered that only this third option could properly eliminate the legal uncertainties that the Group identified). The option was, however, abandoned. The Group noted the arguments in favour of this option, which might merit it being explored in the future, depending on the evolution of the EU's securities markets.

5. PRINCIPLES FOR NEW LEGISLATION ABOUT THE LEGAL EFFECTS OF BOOK ENTRIES

The core principles of the new legislation are set out in this advice, which describes the new legislation, but does not aim to suggest drafting for it. If the advice set out here is found to be attractive, it will be necessary in the future to give definitions to a number of key terms. At this stage, terms are used generically. In particular, all entities in a chain of holdings are 'account providers', except the last account holder, often referred to as the ultimate investor. And all entities are also 'account holders', except the issuer and any operator (typically a CSD) of an account (typically an 'issue account') by which securities are entered in a book entry system.

Throughout the advice, the expression "book-entry rights" is used. This is intended to be a portmanteau expression, covering legal concepts that view the rights related to a book entry being made in favour of an account holder as being transferred by the book-entry, legal concepts that view the rights as arising by virtue of the book-entry, and any variations of those concepts, all as found within the EU. The expression "book-entry rights" is thus neutral between the range of legal approaches within the EU, and is not intended to favour any one of them. It should also be stressed that "book-entry rights" is used in this advice purely as a shorthand label, and is not, and should not be taken as, indicating that the rights that are transferred, are effected, arise and so forth are being given a name in the legal sense.

5.1. Core propositions

The new legislation should be based on the following general propositions:

5.1.1. Book entries on securities accounts are a source of rights for the account holder.

5.1.2. Nothing in the new legislation prohibits or impedes any market practice for holding securities, such as direct holding by the account holder with the issuer, both with and without account providers at the intermediary level, holding securities in a pool, or holding through individually segregated accounts.

5.1.3. The new legislation does not replace existing national property laws concerning securities, nor where relevant company law; however, if such laws are incompatible with the aim of the new legislation, which is to recognise the legal effects of a book-entry, they will need to be conformed.

5.2. Legal effects of book entries

5.2.1. Book-entry rights are:

5.2.1.1. to instruct the account provider to make a book entry on the account for such purpose as to dispose of the rights in favour of a purchaser, or other recipient, to pledge or otherwise charge the rights, to limit the rights in any other way, to change the account on which the rights in the security are held, including by terminating the account with the account provider;

5.2.1.2. to retrieve, or instruct the account provider to facilitate the retrieval of, the securities to which the rights relate by delivery of a certificate or any other means, to the extent provided for under the terms of the issue, the law applicable to the issue, and the law applicable to the account provider;

5.2.1.3. to instruct the account provider, whether specifically or by general instruction, to facilitate the exercise of such rights as the account holder has in respect of the securities to which the book entries relate, such as the right to vote, to receive dividends, interest, income, capital, to subscribe for further securities, the opportunity to consider takeover offers and any other corporate event;

5.2.1.4. to receive from the account provider corporate information communicated to the account provider in that capacity and relevant for the exercise of voting rights or other corporate rights.

5.2.2. The account holder becomes entitled to book-entry rights as of the moment at which the credit entry is made on the account provider’s

books and ceases to be entitled to them upon a debit entry being made.

To ensure that book-entry rights are sufficiently robust, they must be supported by a minimum number of protective rules. The general principles of these rules are set out in sections 5.3 to 5.8 below.

5.3. Rules on Priorities

Book-entry rights have priority over any right, interest or claim of a third party, such as a creditor of the account provider, except where such right, interest or claim arises by mandatory operation of law or where the parties have so agreed.

5.4. Bona fide

An account holder who has a book entry made in his favour, may rely on that book entry against the account provider and against any third party unless he knew or ought to have known that the book entry should not have been made. A rule will be needed within the new legislation specifying how this test is to be applied.

5.5. Prohibition of upper tier attachment

Book-entry rights may be asserted only against the immediate account provider, and in consequence may not be enforced, nor is attachment in respect of such rights, allowed against any upper-tier account provider.

5.6. Account provider insolvency

The insolvency of the account holder's immediate account provider shall not affect book-entry rights and book-entry rights (and corresponding book-entry rights held by the account provider with another account provider) do not form part of the insolvent account provider's estate.

A rule will be needed within the new legislation as to how insufficient assets held by the account provider are shared among its account holders, if there is an incurable shortfall. The formulation of this rule is a matter for policy-makers.

5.7. Rule on validity of credit entries

A credit on a securities account constitutes evidence of the book-entry rights of the account holder.

Book-entry rights will not arise if the book entry is invalid.

Rules will be needed within the new legislation as to the circumstances under which a book entry is liable to be invalidated, and whether the invalidity should be as from the moment the book entry was made, or only as from a later moment, and whether the invalidity should be addressed by the making of fresh reverse entry or by treating the initial book entry as legally void.

The maximum period of time during which a book entry may be invalidated is a matter for policy-makers to decide.

5.8. Option to prohibit conditional settlement

Member States may require that account providers, before making a book entry in respect of particular securities in favour of an account holder, have aggregate holdings designated as holdings for account holders that are at least equal to the aggregate book entries in respect of such securities in favour of their account holders (including the book entry to be made) or, where individual accounts are used, have sufficient coverage at the upper tier for the specific account holder. Where Member States do not so require, and thus allow 'uncovered' or 'conditional' settlement, this fact must be made clear to account holders, so as to provide transparency across the single market.

5.9. Duties of the account provider

In order to preserve book-entry rights, the duties of the account provider must be at least as follows:

5.9.1. to maintain holdings matching the balance of credits on its account holder's accounts;

5.9.2. to pass down to the account holder corporate information that is communicated to it in that capacity and relevant for the exercise of voting rights or other corporate rights;

5.9.3. to pass up the chain of account providers the information and instructions of the account holder in exercise of his rights;

5.9.4. to follow the account holder’s instructions in relation to the account (specific or under the terms of an agreement between the account holder and his account provider);

5.9.5. to segregate own securities from that of its account holders in such a way as effectively to safeguard clients' securities in event of its own insolvency (similar to what is required by article 13(7) of MIFID for some account providers);

5.9.6. if there are insufficient assets at the upper tier to cover the rights of its account holders, and subject to contractual agreement and applicable rules on limitation and exclusion of liability, to replace the missing assets, failing which to reimburse the value of the assets.

5.10. Other rights

Book-entry rights do not affect any other rights of the account holder such as arise by operation of law, or under the account agreement, or under the terms of issue, provided they do not conflict with book-entry rights .

5.11. Subject to the account agreement

The elements of book-entry rights described in 5.2.1.1 and 5.2.1.2 and the duty described at 5.9.1 cannot be altered by contract. Note that the extent of liability for breach of that duty is dealt with at 5.9.6.

Whether the same should be said of the elements of book-entry rights described in 5.2.1.3 and 5.2.1. 4 and the duties described at 5.9.2 and 5.9.3 remains to be decided

when the final detail of the proposal for a directive on the exercise of shareholders' voting rights has been examined.

All the other rights and duties may be modified or disapplied by agreement between the account provider and account holder. In particular, the duties at 5.9.6 may be agreed to arise only where the account provider is at fault .

6. NOTES FOR THE NEW LEGISLATION

6.1. Book-entry rights

The new legislation does not aim at any reconstruction or fundamental change to national ownership concepts, which should be preserved.

The legal effects of a book entry in favour of an account holder arise upon a credit entry to the account (provided the entry is valid). The account holder becomes entitled to the rights as of the moment on which the credit entry is made by the account provider on the account holder's account and ceases to be entitled to them upon a debit entry being made.

Note, however, that the rights that are required to arise are a minimum: in many cases, Member States laws can and will confer further rights. Indeed, in many cases book-entry rights already exist at the national level. For some Member States, the new element will be the attribution of legal effects to entries made on securities accounts, such that the new legislation will create new rights against the account provider. For other Member States, the new legislation will emphasize already existing legal effects against the account provider.

The new legislation cannot and does not seek to change the rights contained in securities, but rather - in some instances - the way these rights are administered, exercised or enforced.

In all cases, book-entry rights are un-classified, un-characterised and doctrinally-neutral at the harmonising EU level. They neither replace nor alter national property rules concerning securities.

6.2. Scope

6.2.1. Securities

The new legislation relates to securities, including rights in securities (as long as they are not merely contractual claims), with the wide meaning attributed to that concept by Community law (MiFID, for example). Whether other financial instruments capable of being credited to accounts should be covered by the new regime and, if so, which ones, is not essential to the group's mandate. The new legislation should not be restricted to ISIN bearing securities, nor to listed securities. It would thus be an open ended list.

6.2.2. Account providers

The new legislation should apply to all account providers. It is assumed that there will continue to be regulation about which entities may and may not act commercially as account providers. The new legislation should cover all, and not merely those who are licensed, so that its protection is not denied to investors at the very moment they need it most (being the default of an unlicensed account provider).

Special rules will be needed to exclude business situations that are not intended to constitute intermediary relationships; this may, for example, arise in the context of certain inter-group relationships. It must also be noted that in some cases the account holder/account provider relationship is not established by contract.

6.2.3. CSDs

The new legislation should apply to all accounts that intermediate between an issuer and investor. This would therefore encompass CSDs when acting in their capacity as account providers. However, the new legislation should not apply to accounts the sole purpose of which is to enter securities in a book-entry system (sometimes referred to as 'issue accounts').

The new legislation is intended to be compatible with the rules of CSDs. It will of course be necessary to investigate whether any CSD-specific exceptions may be merited (for example, to enable DvP), when and if the detail of new legislation has been mapped out.

6.2.4. Account holders

Any account holder, wherever he is positioned in the tier of holdings.

6.2.5. Domestic and cross-border

All book-entries on securities accounts are covered, whether or not they relate to a transaction with a cross-border element, and at whatever level of the chain of holdings they are made. It is in any event practically impossible to restrict the application of the new legislation to cross-border trades only.

6.2.6. Cash leg

The new legislation need not contain rules relating to the cash leg of book-entry settlement.

6.2.7. Terms of issue

The terms and conditions of securities as issued are to be unaffected. Transitional provisions may be needed to cater for existing securities the terms of which pre-suppose any substantive law rules which are inconsistent with the new legislation (if any are found to exist).

6.2.8. Company law

For current purposes, the advice is subject to the proposal for a directive on the exercise of shareholders' voting rights, especially paragraphs 5.2.1.3, 5.2.1.4. and the duties described at 5.9.2 and 5.9.3.

6.3. Regulation

The new legislation does not cover the way in which regulation of the financial markets, in particular of the activities of account providers, may need to evolve.

It may be noted that the effect of the new legislation will be to increase (in some cases) the legal importance of book entries. It may be that regulation will be required to ensure that account providers may safely take on that new responsibility. For example, authorities may feel prompted to make sure that only 'fit and proper', prudentially-authorised account providers are permitted to operate accounts for others, or to impose regulations about the way in which securities accounts should be operated. This is clearly a policy matter and not intrinsically needed for the efficacy of the substantive law regime outlined in these principles. It is, of course, a crucial issue nonetheless.

One further aspect to this issue is the question whether matters which are treated by some as regulatory and by some as substantive should be incorporated as indisputably substantive. The approach taken in this advice is to leave these matters to policy-makers.

6.4. Legislative form

No advice is given at this stage as to legislative form, in particular whether an EU Directive, an EU Regulation, an international Convention, or action at the Member State level would be best. It may be noted that, if the draft UNIDROIT Convention, when it has been negotiated, matches the new legislation described here, its ratification will be preferable to any parallel but separate Community instrument.

Annex: Practical examples of legal barriers, Legal Certainty Group, July 2006

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