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FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
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LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

Consultation document of the Services of the Directorate-General Internal Market and Services

The present document constitutes a questionnaire designed by the services of the Directorate General Internal Market and Services[1]. Its aim is to obtain information from Member States, market participants and other stakeholders, particularly investors, on the necessity to improve the EU-wide legal framework for securities holding and disposition and on how future EU legislation in this field could address the issue. Any future legislation in this field will 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

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[2]. It 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 on whether legislation in the field of securities holding and dispositions should be improved, and if it should, how such improvement should be carried out. The Group presented its Advice to the Commission in August 2008[3]. On the

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1 In co-ordination with the Secretariat-General, the Legal Service, Directorate-General Economic and Financial Affairs, Directorate-General Health and Consumers, Directorate-General Justice, Freedom and Security and Directorate-General Competition.

2 "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.

3 "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.

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basis of this document and an open conference held on its outcome on 23 October 2008 in Brussels, the Commission services are preparing a future legislative initiative in this respect. The initiative will reflect to a large extent the concepts developed by the Legal Certainty Group and information received by means of the stakeholder consultation, on the basis of the present document, will provide the Commission services with important additional elements.

This consultation covers the entire scope of the future legislative initiative, and questions concentrate on the most important technical aspects.

Additional background information to the questions below is comprehensively given in the 2008 Advice of the Legal Certainty Group. Therefore, this questionnaire refers explicitly to that document. An electronic version of the 2008 Advice is available on-line, and a hardcopy can be obtained upon request sent to the e-mail address indicated below.

This consultation will open on **16 April 2009** and close on **11 June 2009**. Answers, to one or several of the questions below, can be submitted to *MARKT-G2@ec.europa.eu*.

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 ON THE RESPONDENT

A) Name and address of the respondent

B) Field of activity of the respondent

C) 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?

D) If the respondent is a securities account provider, please indicate whether the activity relating to holding and dispositions of book-entry securities is

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

(b) 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).

E) If the respondent is an association of stakeholders, how many members do you represent?

1. LEGAL FRAMEWORK OF HOLDING AND DISPOSITION OF BOOK-ENTRY SECURITIES

1.1. General need to harmonise laws in the relevant area

In 2001 and 2003, two reports of a Commission expert group (the first and second "Giovannini Reports") stated that there is increased legal uncertainty in cross-border securities holding. At the source of these uncertainties were the differences in the legal concepts that applied to securities booked to securities accounts. This situation stemmed from the fact that the development of the law applicable to securities did not keep apace with market developments, namely the fact that securities holdings nowadays were evidenced by electronic book entries and the securities were held through a chain of account providers. Therefore, first, book entries on an account should be given identical legal significance throughout the EU. Second, conflict-of-laws rules regarding "proprietary issues" of intermediated securities should be harmonised.

Account holders hold securities with the assistance of account providers, which keep accounts in favour of the account holder to which the securities are credited. Account providers are considered entities like banks, brokers, central banks, central securities depositories and similar. In some national holding arrangements, only one single account provider intervenes in the holding of securities, whereas, in other systems, it might be a multitude of them (in which case, reference is often made to a "holding chain"). However, the kernel of the practicalities of holding is regularly the relationship between one account holder and one account provider.

Additional background information supporting this section can be found in the Introduction and Recommendations 1 and 2, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 1: The far greatest part of securities are held and administered through securities accounts maintained by an account provider (e.g., a bank, a broker, a custodian or similar). What is your estimate regarding the percentage of securities which are *not* held through a securities account?

Question 2: Do you assume that the application of the legal framework for acquisition or disposition of book-entry securities, including the creation of collateral interest, is more complex as soon as there are cross-jurisdictional elements to be taken into account? [Yes, considerably more complex/Yes, slightly more complex/No/I don't know. Please specify and make a distinction between operations occurring inside and outside a securities settlement system, if possible.]

1.2. The legal nature of book-entry securities / minimum harmonisation

The most relevant aspect of any future European legislation 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. However, the certainty that an account holder acquires such position must be accompanied by the knowledge of what exactly he 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, there is a clear need for harmonisation. Beyond this, it appears that the exact legal-conceptual nature (property, shared property, trust, specifically designed right) of the acquired position is only of secondary importance to the acquirer. Consequently, harmonised European legislation might 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.

Starting from a functional point of view, the legal position of the acquirer should be shaped along the practical-economical purposes of an acquisition of securities or interests in securities. Notably, account holders need to know (a) that the securities can be disposed of or used to provide a security interest; (b) whether they can enjoy the rights flowing from the securities (dividends, voting rights), and, (c) whether and to what extent they can change the holding situation, if necessary.

Additional background information supporting this section can be found in Recommendation 4, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 3: Do you think that harmonisation of the law of holding and disposition of book-entry securities should be done by way of minimum harmonisation, i.e. that in general, Member States' law shall continue to define the general legal characterisation of book-entry securities, whereas certain characteristics of book-entry securities are harmonised? [Yes/No/I don't know; please specify]

Question 4: Do you think that book-entry securities should confer upon the account holder the following minimum rights [Yes/No/I don't know, please specify and indicate whether additional elements should be harmonised]:

(a) the right to exercise and receive the rights attached to the securities, as far as the account holder itself is identified by the issuer law as the person entitled to these rights;

(b) the right to instruct the account provider to dispose of the securities;

(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 the applicable law allows holding otherwise than with an account provider.

1.3. Acquisition and disposition of book-entry securities

Different methods are used throughout EU jurisdictions 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.

The future European legislation would probably endorse all six methods.

Furthermore, 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. Under future EU legislation, acquisitions and dispositions would probably 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. However, in some Member States, so-called conditional credits are used to establish a linkage between effectiveness of a book entry and factors external to the account. In such a scenario, the crediting or debiting of book-entry securities to a securities account is made dependent upon the fulfilment of a condition.

However, once an effective book-entry 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. Therefore, future harmonised legislation should provide for a limited set of reasons allowing for "invalidity" or "reversal".

This would also require a harmonised approach to the question of the so-called "good faith acquisition". In most Member States, there are such rules in place in order to protect the parties against the risk of unwinding a sequence of acquisitions. The rules resemble each other as regards their general reasoning, while differing considerably as regards their exact legal requirements and consequences.

As a further issue, harmonisation of rules on priority of interests appears to be necessary. Priority conflicts between several market participants with respect to the same book-entry securities can, and do in practice, arise. The laws of Member States address this question in different manners. Future harmonised legislation will have to provide appropriate rules, striking a balance between the protection of acquisitions effected under methods that are visible on the account (book-entry methods) and those effected under methods which are not visible (non-book-entry methods).

Additional background information supporting this section can be found in Recommendations 5-8, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 5: Do you think that a fix set of methods for acquisition and disposition of book-entry securities (crediting an account; debiting an account; earmarking book-entry securities in an account, or earmarking a securities account; removing of such earmarking; concluding a control agreement; concluding an agreement with and in favour of an account provider) should be available to market participants throughout all EU jurisdictions? [Yes/No/I don't know; please specify]

Question 6: In the event of not all six methods listed in Question 5 becoming available to market participants in all Member States: do you think that the law of any Member State should recognise, in particular in an insolvency proceeding, acquisitions and dispositions effected by one of these methods under the law of another Member State, even if the law of the first Member State does not provide for that method? [Yes/No/I don't know; please specify]

Question 7: Do you think that future legislation should leave to Member States the possibility of making the effectiveness of an acquisition or disposition subject to a condition contractually agreed upon between account holder and account provider, in

particular a condition that a corresponding acquisition or disposition occurs? [Yes/No/ I don't know; please specify]

Question 8: Do you think that there should be a short, harmonised list of conditions giving rise to a reversal of an acquisition or disposition, notably (a) the consent of the account holder; (b) the credit or debit which was made in error; (c) the debit or earmarking or removal of an earmarking which was not authorised. [Yes/No/I don't know, please specify, indicating which one to add/delete, if any]

Question 9: Do you think that account holders in whose favour a credit has been made should be protected against the reversal unless they knew or ought to have known that the credit should not have been made? [Yes/No/I don't know; please specify]

Question 10: Do you think that interests in book-entry securities, notably security interests, which are "visible" in the account, should have priority over book-entry securities which are not "visible" in the account? [Yes/No/I don't know; please specify]

1.4. Integrity of the issue and protection in the event of insolvency of the account provider

As issuers regularly issue a fixed number of securities, the chain of account providers must ensure that the total number of securities belonging to a specific issue does not exceed the number of securities originally issued. To this end, a mechanism should be in place which is designed to avoid imbalances at the level of the account provider. Different legislations use different means to avoid and rectify imbalances that adversely affect the integrity of the issue. None of these national rules gives rise to particular legal concerns when examined in a purely domestic context. However, their diversity amongst EU jurisdictions is problematic since they may lead to conflicting results in relation to the same issue.

Generally speaking, it should be the first aim of account providers and the holding chain as a whole to avoid imbalances between the amount of securities validly credited and the amount issued, since any imbalance persists, at least for some time, raising operational and legal uncertainty, e.g. as regards the payment of dividends and the exercise of voting rights. However, for reasons of operational failure or potential fraud, the practical occurrence of a shortfall cannot be entirely excluded, entailing the necessity of having appropriate rules in place on how to deal with it.

Additional background information supporting this section can be found in Recommendation 9, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 11: Do you think that there should be a legal obligation for account providers to maintain, for securities of the same description, a number of securities or book-entry securities that corresponds to the aggregate number of book-entry securities of that description credited to the accounts of the account holder's clients plus those securities held for its own account, if any? [Yes/No/I don't know; please specify]

Question 12: Do you think that, in case of insolvency of the account provider, securities kept by it for its own account shall be attributed to its account holders, as far as the number of securities kept by the account provider for its account holders is insufficient? [Yes/No/I don't know; please specify]

Question 13: Do you think that a remaining shortage should be shared amongst account holders of that account provider, in the case of its insolvency? [Yes/No/I don't know; please specify].

1.5. Identification of the applicable law

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 current situation raises three questions. First, the conflict-of-laws rules as contained in the three directives are based on slightly different criteria. Second, these rules exclusively apply to the relatively limited scope of the directives. Third, there is a risk that in (admittedly rare) cases the interpretation of where securities accounts are "located" could diverge.

Additional background information supporting this section can be found in section 2.3.2 of the Introduction and section 1.4.2 of Recommendation 1 of the 2008 Advice of the Legal Certainty Group.

Question 14: Have you encountered difficulties in the application of the legal framework regarding holding and disposition of book-entry securities that could be fully or partially attributed to an unsatisfactory conflict-of-laws regime? [Yes/No/I don't know; if yes, please specify the difficulties]

Question 15: Do you think that future legislation on the legal framework of book-entry securities holding and disposition should harmonise issues of substantive law as well as the question of which law is applicable to holding and disposition of book-entry securities, including the creation of security interests? [Yes/No/I don't know; please specify]

Question 15bis: If yes: do you think that a uniform conflict-of-laws rule should govern the issues within the scope of the Settlement Finality Directive, the Directive on Winding-Up of Credit Institutions and the Financial Collateral Directive plus the aspects which are to-date not included in the scope of the three directives? [Yes/No/I don't know; please specify]

1.6. Cost related to aspects addressed in sections 1.1 – 1.5

Question 16: Do you think that holding and disposition of book-entry securities is more costly in cases where the situation involves a cross-jurisdictional element? [Yes/No/I don't know; please specify]

Question 16bis: If yes, could you give your best estimate of the additional cost and specify what types of cost arise?

2. PROCESSING OF RIGHTS FLOWING FROM SECURITIES

Member States' laws governing the processing of rights flowing from securities by account providers considerably differ and are a potential barrier to efficient cross-border

clearing and settlement. The reason is the *de facto* operational "separation" of the investor from the issuer. This is often accompanied by legal incompatibilities as soon as a holding chain crosses jurisdictional borders. Notably, the law of one Member State applicable to the issuer of securities might not tie in smoothly with the law governing holding and settlement in the Member State where such securities are actually held. Against this background, future EU legislation might address this issue from two angles.

First, the jurisdiction of the issuer must ensure that a cross-border investor can exercise rights enshrined in his securities, either directly or through assistance by the chain of account providers, so as to be in a comparable situation to investors holding identical securities in a purely domestic context. Incompatibilities of holding patterns or the fact that the securities are held cross border must not lead to a discrimination of the investor.

Second, 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.

Additional background information supporting this section can be found in Recommendations 12-14, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

2.1. Need to harmonise the relevant laws

Question 17: Do you think that investors face difficulties in exercising rights flowing from securities as soon as they hold through a cross-border holding chain? [Yes, considerable difficulties/Yes, slightly more difficulties than in a domestic context/No/I don't know, if yes, please specify the difficulties]

2.2. Facilitation of the exercise

Question 18: Do you think that the law of Member States should bind account providers to facilitate the exercise of rights flowing from the securities (e.g. by providing the investor, upon demand, with a certificate confirming his holdings; or, by making the investor the account provider's representative with respect to the exercise of the relevant rights {proxy}), where the exercise of rights would be impossible or cumbersome without the assistance of the account provider? [Yes/No/I don't know; please specify]

Question 19: Do you know other cases where assistance of the account provider is a prerequisite for the exercise of the right by the investor? [Yes/No/I don't know; if yes, please specify]

2.3. Exercise of rights by an account provider on behalf of the investor

Question 20: Do you think that Member States' law should make possible the exercise of rights flowing from securities by an account provider on behalf of the investor where the exercise of the rights by the investor himself is impossible? [Yes/No/I don't know; please specify]

Question 20bis: In the affirmative case, do you think that this possibility should be subject

(a) to feasibility on the side of the account provider [Yes/No/ I don't know, please specify, in particular, the exact scope of such feasibility exemption], and/or

(b) to contractually agreed levels of service between the account holder and the account provider? [Yes/No,/ I don't know, please specify].

Question 21: Do you think that Member States' law should make possible the exercise of rights flowing from securities by an account provider on behalf of the investor, in a scenario where the investor does not want to exercise the rights himself? [Yes/No/I don't know; please specify]

Question 21bis: In the affirmative case, do you think that this possibility should be subject

(a) to feasibility on the side of the account provider [Yes/No/ I don't know, please specify, in particular the exact scope of such feasibility exemption], and/or

(b) to contractually agreed levels of service between the account holder and the account provider? [Yes/No/I don't know; please specify].

Question 22: Do you think that an account provider should be bound to exercise, on behalf of the investor, the following rights flowing from securities:

(a) Rights entailing a change of the relevant security itself (e.g. conversions, reorganisation) [Yes/No/I don't know; please specify];

(b) Collection of dividends or other payments and subscription rights [Yes/No/I don't know; please specify];

(c) Acceptance or refusal of takeover bids and other purchase offers? [Yes/No/I don't know; please specify];

(d) Other rights [please specify which and why]

2.4. Passing up and down of the necessary information

Question 23: Do you think that account providers should be bound to pass on information with respect to book-entry securities which is required in order to exercise a right enshrined in the securities which exists against the issuer? [Yes/No/I don't know; please specify];

Question 24: Do you think that this obligation should be restricted to information

(a) which is received "through the holding chain", (i.e. directly either from the issuer or an account provider which maintains an account for the account provider in question, or from the investor or another account provider for which the account provider in question maintains an account.) [Yes/No/I don't know; please specify];

(b) which is directed to all investors in securities of that description [Yes/No/I don't know; please specify]?

Question 25: Would you advise other/additional restrictions to this duty? [Please specify]

2.5. Cost related to aspects addressed in sections 2.1-2.5

Question 26: Do you think that the processing of rights flowing from securities is more costly in case where the situation involves a cross-jurisdictional element? [Yes/No/I don't know]

Question 26bis: If yes, could you give your best estimate of the additional cost and specify what types of cost arise?

3. FREE CHOICE REGARDING INITIAL ENTRY INTO A HOLDING AND SETTLEMENT STRUCTURE, IN PARTICULAR FREE CHOICE OF CSD, BY THE ISSUER

Throughout the EU, there are restrictions regarding issuers' choice as to where securities are initially held. These restrictions come in the form of either market rules or national law and take, for instance, the form of (a) requirements that issues in securities listed in regulated markets have to be deposited exclusively in settlement systems local to those markets; or, (b) requirements that securities listed on a regulated market be submitted to registration with a local registrar for purposes of holding of the issue. However, such restrictions constitute an important barrier to the integration of the EU financial system. Therefore, as a pre-condition for market-led integration of the EU post-trading environment, they might need to be removed.

Additional background information supporting this section can be found in Recommendation 15, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 27: Do you think that an issuer incorporated under the law of an EU Member State should be allowed to arrange for its securities to be initially entered into holding and settlement structures (in particular those maintained by a central securities depository) in, or governed by the law of, another EU Member State? [Yes/No/I don't know; please specify]

Question 28: Do you think that holding and settlement structures for securities, in particular those maintained by a Central Securities Depository, which are governed by the law of an EU Member State, should be open for securities constituted under the law of another EU Member State? [Yes/No/I don't know; please specify]

Question 29: Are there, in your view, issues stemming from other branches of law, such as corporate law, fiscal law, etc., or regulatory/supervisory concerns that could advise against the establishment of free choice by an issuer, as set out above. [Yes/No/I don't know; if yes, please specify the issues]

Question 30: Do you at present incur additional cost because either or both of the above possibilities of choice do not exist? [Yes/No/I don't know/Not applicable]

Question 30bis: If yes, could you give your best estimate of the additional cost and specify what types of cost arise?

4. DUTIES OF ACCOUNT PROVIDERS

Member States 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 investors' 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(I) 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 Directive; hence, at a Community level, 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.

Additional background information supporting this section can be found in section 2.4 of Recommendation 2 and in Recommendation 3, and the accompanying explanatory text, of the 2008 Advice of the Legal Certainty Group.

Question 31: Do you think that all providers of securities accounts established in the EU should be subject to authorisation and supervision in relation to their services of maintaining securities accounts? [Yes/No/I don't know; please specify]

Question 31bis: If no, which account providers should not be subject to authorisation and supervision by competent authorities? [Please designate the type of account provider and specify why.]

Question 32: Do you think that the service of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management (which is a so-called ancillary service under MiFID) should be made an investment service in the sense of MiFID (i.e. inserted in Section A of Annex I of the MiFID and be deleted from Section B)? [Yes/No/I don't know; please specify]

Question 32bis: If yes, do you see any specific difficulties in including certain types of account provider in the full or even a limited scope of MiFID? [Yes/No/I don't know; if yes, please specify the difficulties]

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