Second Advice of the Legal Certainty Group

Solutions to Legal Barriers related to Post-Trading within the EU

August 2008

Legal Certainty Group – LCG

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Executive Summary

The Legal Certainty Group presents to the European Commission its *Second Advice on solutions to legal barriers related to post-trading within the EU*. The Legal Certainty Group is an advisory group made up of 36 legal experts from the post-trading industry, legal practice, academia and competent authorities and a core secretariat provided by the Commission. The Members are drawn from 23 EU Member States and participate in their personal capacity, representing neither their organisations nor their country. The Legal Certainty Group provided its *First Advice* in July 2006 together with an in-depth fact-finding study. Its work is related to, but independent from, that of the CESAME and FISCO groups.

In recent years, post trading has increasingly moved into the focus of policy-makers as an area of special attention. The reason is that, with the sharp rise of the volumes of cross-border transactions in financial instruments, the importance of post-trading arrangements for the proper functioning of an integrated financial market became paramount. And it is clear the integration of the framework for EU trading must be paralleled by integration of EU post-trading, in particular as regards smooth and cost-efficient cross-border clearing and settlement of transactions. The most striking examples of steps that reflect this are the various possibilities to choose a provider under the Markets in Financial Instruments Directive (MiFID) and the Code of Conduct for Clearing and Settlement. The Europe-wide choices these steps offer must be substantiated by a sufficiently flexible post-trading infrastructure throughout Europe.

However, post-trading seems to remain a business that often tends to stop at the national frontiers. The lack of efficiency and cost effectiveness caused by this fact renders EU cross-border post-trading arrangements more cumbersome, more expensive and more ineffective than necessary. Many suggest that this situation even constitutes a competitive disadvantage *vis-à-vis* important markets located outside the EU, especially in those in the USA.

This situation has made the EU step up considerably its efforts in this field, acting on the basis of a long term concept, the two so-called Giovannini Reports, published in 2001 and 2003. These reports describe three spheres of difficulties within the post-trading sector, relating to: (a) technical requirements and industry practices; (b) taxation; and (c) legal certainty. Within these three areas, the Giovannini Reports identified fifteen specific obstacles to an ideal post-trading market, the “Giovannini Barriers”. The Commission's Mandate for the Legal Certainty Group covered the development of concepts capable of dismantling two of the four legal barriers (Barrier 13 on book-entry securities and Barrier 9 on the location of securities) and the legal aspect of one of the industry barriers (Barrier 3 on corporate actions processing).

Barrier 13 deals with the absence of an EU-wide framework regarding the treatment of "book-entry securities". The issue had been identified by the Giovannini Reports as the single most important legal obstacle to a legally sound cross-border framework for post-trading arrangements. The present *Advice* addresses this issue in its Recommendations 1 – 11, which take into account existing Community legislation, notably the Financial Collateral, the Settlement Finality and the Markets in Financial Instruments Directives.

Recommendations 1 – 11 propose a harmonised legal framework within the EU comprehensively addressing legal effects of book-entries made to securities accounts. This part of the *Advice* is built on the fact that modern structures for securities holding and settlement of securities operate on the basis of services provided by account providers. Credits in securities accounts play a predominant role in practice throughout modern financial

markets. Therefore, it seems natural to take the securities account maintained by an account provider as starting point for legal harmonisation, prescribing that all acquisitions and dispositions effected through an account should have harmonised legal effects throughout the EU financial market.

Recommendations 1 – 11 deliver a set of rules which cover all legal aspects that need to be addressed in this context: the methods for acquisition and disposition; the minimum content of the acquired position; effectiveness and reversal; the protection of the acquirer; priority issues; the integrity of the number of securities; instructions; and, the possibility of attachments. It is important to note that the present *Advice* recognises the diversity of legal concepts underlying securities holding and settlement throughout the Member States. Consequently, it takes a functional approach of harmonisation, as opposed to one attempting to harmonise fundamental legal concepts.

Barrier 3 addresses differences in national legal provisions affecting the processing of corporate actions. The legal aspects covered by Recommendations 12 – 14 of this *Advice* are intended to complement harmonisation of operational issues which are dealt with by the CESAME Group in co-operation with relevant industry groups.

The background of Recommendations 12 – 14 is that legal uncertainty in corporate actions processing is due to modern securities holding and settlement structures, where the issuer-investor relationship is supplemented by several legal relationships involving one or more account providers. In some jurisdictions, legal relationships involving account providers have even substituted the direct legal relationship between issuer and investor. This leads to a multiplication of legal relationships. Consequently, the various rights and obligations related to administration of the securities become more complex from the operational and even legal point of view.

However, difficulties in corporate action processing are widespread. They relate, for example, to voting at a general shareholders' meeting, to incompatible notification processes, to the different identification of the moment of transfer of ownership, to an incompatible record date, ex date or payment date, to different standards in electronic communication between investor, account providers and issuer, or to differing rules on the liability for wrongful translation of documents supporting corporate actions, etc.

Recommendations 12 – 14 do not aim to address the full range of detail within these many inconsistencies; they exclusively deal with obstacles arising in connection with cross-border holding of securities through securities accounts maintained by account providers. Thus, the *Advice* proposes to dismantle existing obstacles with two global and functional rules which complement and broaden the relevant rules contained in the Shareholders' Rights Directive: first, a rule ensuring that a cross-border investor can exercise rights enshrined in his securities, either directly or through assistance by the chain of account providers; and, second, a rule addressed to account providers obliging them to provide a harmonised level of basic assistance to investors as regards the exercise of these rights.

Barrier 9 embraces restrictions regarding the location of securities. The scope of this barrier covers both certificated (that is to say, paper-based) and dematerialised securities; therefore, "location" is not understood in the sense of location of a tangible asset only. Rather, the matter focuses on the entering of securities (both dematerialised and certificated) into the circuit of holding and settlement through securities accounts, normally by entering them into a Central Securities Depository. Restrictions regularly come in the form of either market rules or national law; for example, the requirement that issues of securities listed in regulated markets should be deposited exclusively in the local Central Securities Depository.

Recommendation 15 takes the opinion that securities constituted under the law of a Member State should be capable of being initially entered into a Central Securities Depository governed by the law of another Member State. To this end, the issuers' jurisdiction must allow for the securities to be initially entered into a foreign Central Securities Depository; and all EU jurisdictions must allow local Central Securities Depositories to open their holding and settlement structures for foreign securities.

The Second Giovannini Report already indicated that there was a link between the matter of the issuer's free choice of the location of securities, and impediments to the free choice of the location of clearing and settlement of securities (Giovanni Barrier 2), which is addressed in the European Code of Conduct for Clearing and Settlement and the MiFID. Recommendation 15 complements the Code of Conduct and the MiFID in this regard, and assures the realisation of efficiency benefits they create in stimulating competition, by improving the framework for a potential consolidation of post-trade infrastructures. Whereas the Code of Conduct contains measures addressed to account providers, the main purpose of the removal of Barrier 9 is to give *issuers* the choice of the location of securities and thereby ensure competition with respect to the services offered by CSDs.

* * *

Finally, it is worth noting that many Recommendations included in the present *Advice* are not only highly complex from the legal point of view, but furthermore connected to central areas of Member States' law, such as company law and insolvency law. Against this, and taking into account the different legal traditions in which the 36 expert Members of the Legal Certainty Group are rooted and the different functions they hold, it seems natural that not every Member is in a position to agree to every single paragraph of the present *Advice.* However, the Group is proud to present an entirely consensus-based *Advice*, which in very few instances introduces alternative solutions to the route taken by the majority of the Group.

Summary of Recommendations

Part I

Legal Effects of book entries (Barrier 13)

Recommendation 1 – Scope of future EU Legislation

The legal certainty and efficiency of cross-border settlement of securities transactions suffer from lack of clarity and certain incompatibilities in the EU Member States' legal framework underlying the use of book entries in securities accounts. The EU should therefore take legislative action to address the legal effects of book entries in securities accounts for the purpose of the acquisition, disposal and creation of security interests over securities, and related aspects, thereby complementing a range of other EU and non-EU initiatives.

Recommendation 2 – Core Elements and Terminology

EU legislation should recognise that today's securities holding systems operate through the relationship between account holder and account provider and book entries in securities accounts. However, this is without prejudice to any link between investor and issuer. A further fact is that there may be one or more account providers involved in a chain of holding.

Recommendation 3 – Core Role of Account Providers

3.a In an environment of holding and settlement of securities through account providers, the protection of the rights of account holders as well as the ability to ensure the continuity of the relationship between the issuer and the investors depend heavily upon the careful and diligent exercise of a number of duties by the account provider.

3.b Member States' law should reflect that

- safeguarding book-entry securities;
- following instructions exclusively in accordance with the account agreement;
- processing corporate actions to the extent provided for by the account agreement and the applicable law; and,
- reporting on securities movements and holdings in a manner, with a scope and regularity as prescribed by the account agreement and the applicable law

constitute core duties of any account provider in that respect, in addition to any duty to fulfil any other obligation that might arise under the account agreement or the applicable law.

3.c Account providers should not be allowed to exclude their liability for wilful misconduct or gross negligence in the performance of these core duties.

Recommendation 4 – Book-Entry Securities

4.a The law of the Member States should confer upon account holders a legal position in respect of securities credited to the account holders' securities account which includes the following rights:

- first, to exercise and receive the rights attached to the securities (e.g. voting rights, dividends), as far as the account holder itself is entitled to these rights under the applicable law;
- second, the right to instruct the account provider to dispose of the securities;

- third, the right to instruct the account provider to arrange for holding the securities in a different manner, i.e. holding them either with another account provider or otherwise than with an account provider, as far as permitted under the applicable legal framework.

4.b The conceptual nature of the legal position (e.g., property right, or other) should be left to the national law.

4.c In the case of a security interest or other limited interest the applicable legal framework can restrict the above set of rights, for example exclude the right to receive dividends or the right to dispose of the position.

4.d The legal position which is thus harmonised in its minimum content should be described by a common notion. The present *Advice* uses the notion "book-entry securities".

Recommendation 5 – Effectiveness of Acquisitions and Dispositions of Book-Entry Securities and Interests therein

5.a Future EU legislation should require Member States' law to recognise acquisitions and dispositions which are rendered effective by one of the following methods:

- crediting an account;
- debiting an account;
- earmarking book-entry securities in an account, or earmarking a securities account;
- concluding a control agreement;
- concluding an agreement with and in favour of an account provider.

5.b The above methods prevail over any other method permitted by the applicable law.

5.c Acquisitions and dispositions arising by mandatory operation of law are effective and have the legal attributes, in particular rank, following the provisions of the applicable law.

Recommendation 6 – Effectiveness and Reversal

6.a An acquisition or disposition using one of the methods set out in Recommendation 5 should be immediately effective *vis-à-vis* the account provider and against third parties, including the account provider's insolvency administrator and creditors in its insolvency proceedings. No further steps may be required by national law to render the acquisition or disposition effective. Member States' law may stipulate that the effectiveness can be made subject to a condition agreed upon between account holder and account provider.

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

6.c Member States' law should prescribe that book entries can be reversed under the following circumstances:

- in the case of consent of the account holder;
- in the case of erroneous crediting;
- in the case of unauthorised debiting, earmarking or removal of an earmarking.

6.d By means of reversal the reversible book entry is undone, to the extent possible, by the making of a converse book entry.

6.e The national law can 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.

Recommendation 7 – Protection of Acquirers against Reversal

7.a EU legislation should include a harmonised rule protecting the crediting of an account or earmarking of book-entry securities or of an account against reversal.

7.b An account holder should be protected against reversal of a credit unless it knew or ought to have known that the account should not have been credited.

7.c A person in whose favour an earmarking has been made should be protected against reversal of this earmarking unless it knew or ought to have known that the earmarking should not have been made.

Recommendation 8 – Priority

8.a Interests in the same book-entry securities which are acquired by earmarking rank amongst themselves in chronological order.

8.b Interests in the same book-entry securities which are acquired by control agreement or an agreement with and in favour of the account provider rank amongst themselves in chronological order.

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

8.d Parties can deviate from the above rules by agreement. Such agreement cannot affect the rights of third parties.

8.e Security interests created by mandatory operation of law should have the priority attributed by that law.

Recommendation 9 – Integrity of the Issue

9.a EU legislation should provide that an account provider has to maintain a number of book-entry securities that corresponds to the aggregate number of book-entry securities credited to the accounts of its account holders or held for its own account.

9.b In the event that an imbalance occurs, EU legislation should require application of one or more of the following measures:

- the reversal of erroneous bookings;
- the buy-in of missing securities;
- the attribution of securities held by the account provider for its own account to the account provider's account holder (clients);
- in the event of insolvency of the account provider, the loss represented by the missing securities is to be shared amongst the account holders following the law of Member States or the rules of the relevant settlement systems in accordance with the relevant law.

Recommendation 10 – Instructions

10.a EU legislation should ensure that an account provider is neither bound nor entitled to give effect to any instructions with respect to book-entry securities given by any person other than his account holder or a person legally entitled to do so.

10.b An account provider shall execute instructions given by the entitled person promptly and with due care.

10.c The above rules can be modified by the account agreement.

Recommendation 11 – Attachments

11.a EU legislation should provide that creditors of an account holder may attach book-entry securities only at the level of the account provider of that account holder.

11.b Creditors of an account provider may not 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 (segregated client accounts). Where the law provides for a presumption that accounts opened by an account provider with a second account provider contain clients' assets, the presumption applies.

Part II

Differences in national law affecting corporate action processing (Barrier 3)

Recommendation 12 – Scope of Legislation on Processing of Corporate Actions

EU legislation is needed in order to dismantle legal obstacles to corporate actions processing arising from cross-border holding of securities through chains of account providers.

Recommendation 13 – Recognition of Different Holding Patterns for the Purpose of Processing of Corporate Actions

13.a EU legislation should require the law of Member States to recognise and be compatible with holding patterns used in other jurisdictions in order to improve corporate action processing in a cross-border environment.

13.b In particular, Member States' law should recognise

- holding through one or more account providers;
- holding through omnibus accounts; and
- holding of securities by an account provider acting in its own name for the account of another person or other persons,

and investors should not be discriminated by the law of the issuer, as regards in particular the exercise of the rights enshrined in their securities, due to the fact that they use one of the above holding models under a law different from the law of the issuer.

13.c This Recommendation does not aim at changing Member States' law determining whom an issuer is bound to recognise as holder of its securities or specifying which particular holding pattern or patterns account providers should offer to their domestic account holders.

Recommendation 14 – Harmonised Role of Account Providers in the Processing of Corporate Actions

14.a EU legislation should provide for a framework regarding the passing up and down of relevant information received through the chain of account providers, which is required in order to exercise a right enshrined in the security *vis-à-vis* the issuer and which is targeted at all investors in securities of the same description.

14.b The legislation should at least foresee that the account provider is facilitating the exercise of rights by the account holder *vis-à-vis* the issuer or a third party either by the account holder acting directly or by the account provider next in the chain upon authorisation and instruction by the account holder.

14.c Exercise of rights on behalf of the account holder on the basis of an authorisation or instruction should be required for at least the collection of dividends and interests, for the exercise of subscription or exchange rights as well as for the acceptance of takeover bids, mergers, other purchase offers and conversions.

Part III
Restrictions on the location of securities (Barrier 9)

Recommendation 15 – Initial Entry in Any Member State

15.a Securities constituted under the law of a Member State should be capable of being initially entered into holding and settlement structures for securities, in particular those maintained by a central securities depository, in or governed by the law of any Member State.

15.b The law of Member States should allow an issuer 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 any Member State. To this end, rules should be abolished that explicitly or implicitly prohibit or impede such initial entry, as for example:

- rules requiring securities to be initially entered into a local holding and settlement structure;
- rules requiring securities to be registered with a local registrar; or,
- rules requiring securities to be acquired and disposed of through a local holding and settlement system.

15.c The law of Member States should allow for holding and settlement structures for securities, in particular those maintained by a Central Securities Depositories, to be open for securities constituted under a law different from the law governing the initial entry into such structures. This concerns, for example, the following rules which should be abolished:

- rules requiring securities which are not constituted under the local law to have the same form (dematerialised or certificated) as local securities; or,
- rules that apply discriminatorily against securities which are not constituted under the local law with regard to holding, acquisition and disposition.

Introduction

In recent years, post-trading has increasingly moved into the focus of policy-makers as an area of special attention. The reason is that, with the sharp rise of the volumes of cross-border transactions in financial instruments, the importance of post-trading arrangements for the functioning of an integrated financial market became paramount. And the integration of the framework for EU trading must be paralleled by integration of EU post-trading, in particular as regards smooth and cost-efficient cross-border clearing and settlement of transactions. The most striking examples of steps that reflect this are the various possibilities to choose a provider under the Markets in Financial Instruments Directive (MiFID)[1] and the Code of Conduct for Clearing and Settlement. The Europe-wide choices these steps offer must be substantiated by a sufficiently flexible post-trading infrastructure throughout Europe.

However, post-trading seems to remain a business that often tends to stop at the national frontiers. The lack of efficiency and cost effectiveness caused by this fact renders EU cross-border post-trading arrangements more cumbersome and more ineffective than necessary. Many suggest that this situation even constitutes a competitive disadvantage *vis-à-vis* important markets located outside the EU, especially in the USA.

1 EU initiatives in the field of post-trading

This situation has made the EU step up considerably its efforts in this field, acting on the basis of a long-term concept, the first part of which was the "First Giovannini Report" published in 2001[2]. The expert group under the lead of Alberto Giovannini made clear that difficulties in the post-trading sector existed within three spheres[3]: (1) technical requirements and market practices; (2) taxation; and (3) legal certainty. Within these three areas, the Giovannini Report identified fifteen specific obstacles to an ideal post-trading market, the "Giovannini Barriers". Later, in its Second Report, the Giovannini Group addressed the question of which concrete actions should be undertaken to eliminate the problems identified in the First Report[4].

In response to these Reports, the EU Commission issued a Communication to the Council and the European Parliament setting out the roadmap for future action with a view to enhancing the efficiency and safety of post-trading arrangements across Europe[5]. In this paper, the EU Commission proposed the following measures:

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1 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (hereinafter "MiFID").

2 Cross-Border Clearing and Settlement Arrangements in the European Union, The Giovannini Group, November 2001 (hereinafter "First Giovannini Report").

3 First Giovannini Report, pp. 44, 50 and 54 *et seq*.

4 Second Report on EU Clearing and Settlement Arrangements, The Giovannini Group, April 2003 (hereinafter "Second Giovannini Report").

5 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, 28.4.2004 (hereinafter "Commission 2004 Communication").

– with respect to issues founded in technical requirements and market practices, to set up the CESAME Group[6] and to draw up a Directive on clearing and settlement[7] which addressed questions of (1) rights of access and choice, (2) a common regulatory framework, and (3) governance;

– in the fields of taxation, the Commission proposed to base further action on the *Advice* of an expert group to be set up for this purpose, namely the FISCO Group[8], and,

– equally, in the field of law, the Commission decided to take specialist *Advice* as a starting point for future initiatives and created the Legal Certainty Group[9].

All fifteen Giovannini Barriers being addressed simultaneously, it was apparent from the outset that the timeframe for removing them would vary, given the different nature and complexity of the relevant issues. This is all the more true as the addressees of the barriers, i.e. the entities called upon to remove them, are not necessarily identical: generally, technical and operational issues are rather proprietary to the private-sector operators in the post-trading market, whereas tax and legal issues need to be dealt with by the competent authorities and legislators.

The present *Advice* focuses exclusively on the legal impediments to an efficient and safe cross-border post-trading environment in the EU.

2 Overview of relevant legal issues

The First Giovannini Report clearly identified three different areas where legal issues were an obstacle to efficient and safe cross-border clearing and settlement in the EU. However, in the later process, the Commission became aware of additional areas that had a clear footing in the area of law and therefore needed to be addressed (also) from the legal side.

2.1 Legal barriers initially identified by the Giovannini Reports

The First Giovannini Report identified three barriers relating to legal certainty[10]. The Report acknowledged the high degree of complexity in removing legal obstacles in the post-trading field, as this effort would necessarily affect basic legal concepts of the Member States, as national legal systems relating to the nature of and dealings in securities were significantly diverse across the EU.

The First Giovannini Report highlighted three dichotomies which were – and are still – considered to be at the very basis of most of the legal issues at stake:

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6 "Clearing and Settlement Advisory and Monitoring Group", http://ec.europa.eu/internal_market/financial-markets/clearing/cesame_en.htm.

7 Instead of actually proposing such a Directive, the EU Commission initiated the creation of a Code of Conduct on Clearing and Settlement; cf. also Draft Working Document on Post-Trading, 23.05.2006, all information available http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm#code.

8 Fiscal Compliance Group, http://ec.europa.eu/internal_market/financial-markets/clearing/compliance_en.htm.

9 Legal Certainty Group (hereinafter LCG); http://ec.europa.eu/internal_market/financial-markets/clearing/certainty_en.htm.

10 First Giovannini Report, p. 54 *et seq.*

First, the difference between equities and debt securities, the former being inseparably linked to the national company law whereas legal arrangements regarding the latter were relatively flexible.

Second, the different nature of the legal position which an account holder "owns" as soon as securities were booked to his account, as in some jurisdictions he enjoyed full and unshared property whereas in others he received a position that was in comparison "inferior", as, for example, a shared or indirect property interest or a mere claim against the account provider.

Third, the fact that in some jurisdictions all or some types of securities were incorporated in or represented by a certificate whereas in other countries securities were "dematerialised" i.e. only existed as entries in (electronic) registers.

Consequently,

- the Report identified the absence of an EU-wide framework for the legal treatment of securities as the most important source of legal risk in cross-border transactions and called upon addressing the issue within the framework of Barrier 13.
- another issue highlighted by the First Giovannini Report as Barrier 14 related to the treatment of bilateral netting.
- the third aspect, based on the diversity described above, was the uneven application of conflict-of-laws rules, which was dealt with under the header of Barrier 15.

2.2 Legal aspects of other barriers

In addition to the three areas clearly denominated as "legal barriers" by the two reports (Barriers 13, 14 and 15), the Commission identified legal elements which were included in other Barriers.

The Commission stated that, notably, differences in national legal provisions affecting corporate action processing needed to be addressed. Already the Giovannini Reports, within the sphere of Barrier 3, had identified this issue as closely related to national corporate law, in particular in the context of determining the moment at which a purchaser of securities has to be treated as their owner[11].

Similarly, a strong legal aspect was highlighted within the scope of Barrier 9 which addresses restrictions regarding the location of securities[12]. This barrier had to be dealt with clearly in a legal project, as the aforementioned restrictions could be found either in national law linking listing in a particular market with the use of the local CSD or in national company law.

2.3 Mandate of the Legal Certainty Group: Barriers 13, 3 and 9

Hence, the Legal Certainty Group was mandated to give advice on Barrier 13, the legal aspects of Barrier 3 and on Barrier 9[13]. It was not mandated to deal with Barriers 14 and 15. The Group delivered the first part of its *Advice* to the Commission in July 2006[14].

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[11] Second Giovannini Report, p. 10; Commission 2004 Communication, p. 10.

[12] First Giovannini Report p. 49 *et seq.*; Second Giovannini Report, p. 18 *et seq.*; Commission 2004 Communication p. 25.

[13] Cf. Commission 2004 Communication, p. 24 et seq.; Mandate for the Legal Certainty Group, January 2005, p. 1, http://ec.europa.eu/internal_market/financial-markets/docs/certainty/mandate_en.pdf.

2.3.1 Excluded: Barrier 14

The First Giovannini Report set out that netting was generally recognised in one form or another in most EU countries[15]. However, its availability was often limited to specific products, types of counterparty or forms of contractual documentation. This led to the need for a detailed analysis of each transaction before it could safely be assumed that netting would be possible. There was agreement that any legal uncertainty in this area needed to be removed.

By the time the Second Giovannini Report was prepared, the Financial Collateral Directive had, in the meantime, been adopted. The report stated that by the implementation of this Directive, Barrier 14 would be removed for most purposes, as the Directive expressly recognised close-out netting[16]. This view was also confirmed by the EU Commission[17]. Consequently, the Commission did not include Barrier 14 within the mandate for the Legal Certainty Group.

However, since then, industry has expressed its interest in a review of the netting-related *acquis communautaire* and the Commission is currently considering further steps in this regard.

2.3.2 Excluded: Barrier 15

Barrier 15 was explained by the First Giovannini Report[18] as follows: almost all transactions involved a cross-border element. Therefore, more than one jurisdiction was relevant to most transactions. As the legal concepts which applied to securities kept within holding systems varied considerably, similarly the answer to the conflict-of-laws question could differ, up to irreconcilable conflicts between two or more jurisdictions. The need for harmonisation of the conflict-of-laws rule had therefore been widely recognised, which was also reflected by the fact that three legislative measures addressed the issue: (i) the Settlement Finality Directive, (ii) the [at the time of the report] proposed Financial Collateral Directive, and, (iii) the [at the time of the report] proposed Hague Securities Convention. They all followed the "Place of the Relevant Intermediary Approach" (PRIMA) which made the jurisdiction of the relevant securities account decide on the applicable law.

The approach of the Hague Securities Convention[19] was subsequently changed in the course of the discussions. As opposed to the original PRIMA concept, used by the Financial Collateral Directive, the Settlement Finality Directive and also by the Winding-Up

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[14] Advice of the Legal Certainty Group, 28.07.2006 (hereinafter "*2006 Advice*"), http://ec.europa.eu/internal_market/financial-markets/docs/certainty/advice_final_en.pdf

[15] First Giovannini Report, p. 57.

[16] Second Giovannini Report, p. 12 *et seq*.

[17] Commission 2004 Communication, p. 23.

[18] First Giovannini Report, p. 57 *et seq*.

[19] Convention on the law applicable to certain rights in respect of securities held with an account provider, of 5 July 2006 (adopted in December 2002, the Convention officially indicates however the date of the first signature), http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72.

Directive[20], the Convention's rule is no longer based on an attempt to "locate" a securities account, nor does it require locating the underlying securities. This becomes evident when the relevant texts are compared:

Article 9(1) FCD: "Any questions with respect to any of the matters specified in paragraph 2 arising in relation to book-entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. […]"

Article 9(2) SFD: "Where securities […] are provided as collateral security to participants […], and their right […] with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights […] shall be governed by the law of that Member State."

Article 24 Winding-Up Directive: "The enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralised deposit system held or located in a Member State shall be governed by the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located."

Article 4(1) Hague Securities Convention: "The law applicable to all the issues specified in Article 2(1) is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. […]"

The Hague Securities Convention adopts as the relevant conflict-of-laws criterion the explicit agreement by the parties in the account agreement. Consequently, the Second Giovannini Report[21] highlighted this newly emerged divergence and called for a resolution of inconsistencies between the Hague Securities Convention and the existing *acquis communautaire*. Subsequently, the EU Commission proposed to sign the Convention and afterwards, bring the SFD and FCD in line with it[22].

In the following debate, a number of EU countries raised concerns about the approach taken by the Hague Securities Convention, allowing for a large degree of freedom of choice and being mainly beneficial for big custodians to the detriment of smaller ones, and advocated to stick to the PRIMA rule contained in the three Directives. The EU Council is heavily divided over this issue and the European Parliament, in a resolution of December 2006[23], expressed its clear preference for the PRIMA-rule.

In the light of these developments, the EU Commission will have to consider by which means global and European harmonisation could be sensibly balanced. Should the EU decide not to sign the Hague Securities Convention, global harmonisation could fail at least for the coming years, though the US and Switzerland already signed the Convention on 5 July 2006.

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[20] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001on the reorganisation and winding-up of credit institutions, hereinafter "Winding-Up Directive".

[21] Second Giovannini Report, p. 13.

[22] Commission 2004 Communication, p. 24; Proposal for a Council Decision, COM(2003)783final, 15.12.2003; and subsequently Commission staff working document, SEC(2006)910, 03.07.2006; both available http://ec.europa.eu/internal_market/financial-markets/hague/index_en.htm.

[23] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2006-0608+0+DOC+XML+V0//EN&language=RO.

Clearly, something needs to be done at European level: first, some say that the classical PRIMA approach, as included in the Directives, bears the difficulty that in (rare) cases the interpretation of where securities accounts are "located" could come to diverging results depending on the jurisdictions involved. Second, PRIMA at present exclusively applies to the scope of the Directives, which is to collateral transactions in the context of payment and settlement systems/central bank operations on the one hand, and to counterparties conducting collateral operations (see *supra*) on the other, which means that a huge part of the securities booked to accounts follow other, non-harmonised, rules.

Part I
Legal effects of book entries (Barrier 13)

From the beginning, the absence of an EU-wide framework regarding the treatment of book-entry securities had been identified as the single most important legal obstacle to a legally sound cross-border framework for post-trading arrangements.

Recommendation 1 – Scope of future EU legislation

The legal certainty and efficiency of cross-border settlement of securities transactions suffer from lack of clarity and certain incompatibilities in the EU Member States' legal framework underlying the use of book entries in securities accounts. The EU should therefore take legislative action to address the legal effects of book entries in securities accounts for the purpose of the acquisition, disposal and creation of security interests over securities, and related aspects, thereby complementing a range of other EU and non-EU initiatives.

1.1 Scope as set by the Giovannini Reports

The First Giovannini Report[24] named two main areas in which legal uncertainty materialised: providing collateral over securities and defining the "finality" of a securities transaction. 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 the development of the market, namely the fact that securities holdings nowadays were evidenced by electronic book entries and the securities were held through a chain of account providers. Even though terminology was, in many cases, similar, the legal make-up differed in detail to an extent that made cross-border holding, disposition (including by way of collateral) and acquisition a legally highly complex phenomenon.

The Second Giovannini Report delivered important clarification[25] as regards the need for action under Barrier 13, as well as with regard to the direction to take. In a first step, it emphasised that the starting point to the resolution of this issue should be the role of the securities account. The basic idea was that book entries on an account should be given the same legal significance throughout the EU. Second, the report made clear that harmonisation of the conflict-of-laws rules regarding "proprietary issues" of intermediated securities (*cf.* Barrier 15) was not far-reaching enough to resolve the issue. This was the case because, regularly, not all aspects of a cross-border legal situation regarding intermediated securities were covered by one and the same conflict-of-laws rule. This meant that ultimately it was very probable that substantive law of two or more jurisdictions had to interact, even if there was a common conflict-of-laws rule for "proprietary issues" in place.

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24 First Giovannini Report, p. 56 *et seq*.

25 Second Giovannini Report , p. 13.

1.2 Linkage with existing EU legislative measures

Some aspects regarding the legal framework for book-entry securities are already addressed by the current legal framework in the EU, as already highlighted in the Commission's 2004 Communication. However, the legal framework set by pre-existing EU directives is designed to address very specific legal aspects of the post-trading environment, i.e. the personal and material scope of its various measures are restricted. However, measures proposed by the present *Advice* are heavily interwoven with these pre-existing rules. Therefore, the Recommendations contained in this *Advice* and any future measures built on them have to be shaped in a manner that allows for their smooth integration into the current EU legal framework for holding and settlement of securities through book entries in accounts. The main EU Directives which are relevant in this context are described below:

1.2.1 Settlement Finality Directive

The Settlement Finality Directive[26] of 1998 already eliminated part of the legal risk inherent in the holding and settlement of securities held through securities accounts, as it applies, *inter alia*, to designated securities settlement systems, to the participants in such a system and to collateral provided under the arrangements of such a system. It stipulates the effectiveness and irrevocability (also referred to as "finality") of transfer orders, once they are entered into such systems, even in the event of insolvency of one or more system participants (Article 3). Furthermore, the Directive aims at abolishing certain insolvency rules that aim at protecting the creditors of the insolvent and which, for this purpose, render invalid certain transactions which appeared prior to the insolvency (Article 7).

Both the personal and material scope of this directive is restricted. It does not cover market participants which are not a system or system participants; hence, all other players, institutions that are not participants, as well as natural persons, would not benefit from the protection offered by the Settlement Finality Directive. Furthermore, even those market participants that do come within the scope are only protected against the revocation, in case of insolvency, of transfer *orders;* the question of the legal effectiveness of *acquisitions* and *dispositions*, including the creation of *security interests*, remains entirely uncovered.

1.2.2 Financial Collateral Directive

The Financial Collateral Directive[27] removes major impediments to the use of securities as collateral, in particular in a cross-border situation by establishing a largely harmonised framework for such transactions. It covers collateral in the form of financial instruments and cash provided under an arrangement either involving transfer of title or by way of security to a collateral taker (i.e. pledge, charge, lien, etc). Formalities regarding the creation of a collateral interest are abolished (Article 3) and procedures and formalities for the enforcement of collateral in a default situation are simplified (Article 4). Furthermore, the directive gives the parties the possibility to agree on a right of use over securities provided as collateral (Article 5). Lastly, it institutionalises certain market practices, namely close-out netting, top-up collateral and substitution of collateral securities.

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[26] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.

[27] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

The material scope of the Financial Collateral Directive represents clearly a very important part of the issue covered by Barrier 13. However, it exclusively relates to the creation of collateral interests and to the above-cited market practices. The basic question of how acquisitions and dispositions, including the creation of security, are rendered legally effective is only touched upon at the surface. Furthermore, the personal scope of the Directive extends basically to "financial institutions" whereas natural persons are excluded.

1.2.3 MiFID

The Directive on markets in financial instruments (MiFID)[28] requires Member States to further harmonise the rules governing investment services and the pursuit of investment activities. It aims to give investment firms an effective single passport to operate across the EU and to provide a high level of investor protection. It furthermore seeks to establish a comprehensive regulatory framework governing the execution of investor transactions by exchanges, other trading systems and investment firms.

In respect of intermediated holding of securities, two aspects of the Directive are of particular interest. First, with respect to safeguarding clients' assets, the MiFID states that an investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights. This principle is further specified in the MiFID Implementation Directive[29]. Second, the MiFID ensures that all orders, including those involving a cross-border element, are processed and settled in a non-discretionary and objective manner and that investment firms have non-discriminatory access to clearing and settlement facilities in the EU, *cf.* Articles 39(d) and 46 of the MiFID. Against this new freedom, cross-border holding and settlement can be expected to significantly increase in the years to come. Therefore, a harmonised legal framework in this area is all the more necessary.

1.2.4 Winding-up Directive

The Winding-up Directive of 2001[30] introduces the home-state control principle for insolvencies of credit institutions with branches in other Member States. The directive contains some provisions of relevance to collateral arrangements and netting as it provides for the recognition of set-off in case of insolvency.

Again, the personal scope of this directive is limited to credit institutions. The material scope relates only in a cursory manner to the content of Barrier 13.

1.2.5 Result: gaps in the current EU legal framework

The current EU framework dealing with the legal treatment of securities holding and settlement through account providers addresses several very important issues. Notably, legal inconsistencies as regards the provision of collateral over investment securities have been removed by the Financial Collateral Directive. Furthermore, the ring-fencing of securities settlement systems against the insolvency of participants under the rules of the Settlement Finality Directive is a great improvement.

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[28] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (hereinafter “MiFID”).

[29] Article 16(1)d) of the MiFID Implementing Directive of the EU Commission.

[30] Directive 2001/24/EC of the European Parliament and the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (hereinafter "Winding-up Directive").

However, important gaps still need to be filled and the current framework appears rather like a patchwork. In particular, the personal scope of the measures in place is different for all four directives as described above (designated systems – financial institutions - investment firms – credit institutions). This means that not all of the four aforementioned legal measures apply to all market participants. The Settlement Finality, the Financial Collateral and Winding-Up Directives, as they are primarily designed in respect of the stability of the financial system, do not even cover all small financial market participants or private investors.

As regards the material scope, the picture is equally still incomplete: in particular, the single most important issue, namely the validity of an acquisition of book-entry securities, is still not harmonised. In practice, securities are acquired by crediting and disposed of by debiting a securities account. However, the legal underpinnings of this market reality differ considerably between jurisdictions. As the entire world of dealings in securities held through securities accounts is based on book-entries, even a slight uncertainty regarding their legal effects could, under exceptional circumstances, affect the reliability of the entire process of clearing and settlement.

1.3 Linkage with neighbouring EU initiatives

1.3.1 Target2-Securities

TARGET2-Securities (hereinafter "T2S") is the Eurosystem's initiative to provide borderless settlement services on a voluntary basis to CSDs. It is designed to be a technical platform for CSDs for the settlement of securities against central bank money, concentrating securities and cash settlements within a single IT infrastructure. T2S will not replace CSDs nor the contractual relationship between CSDs and their users. Consequently, the introduction of T2S will have no impact on the substantive legal issues underlying Barrier 13. However, T2S may increase (even in the absence of legal harmonisation of substantive law) the predictability of and legal certainty on the completion of the legal transfer, due to the transfer order finality on both sides of a cross-system transaction and the standardised simultaneous settlement in T2S on the accounts of both CSDs involved, resulting in the legal exchange of cash and securities. However, the further harmonisation of conflict-of-laws and substantive law could facilitate the operation of T2S, and enhance it from a legal point of view.

1.3.2 ECB-CESR Recommendations

The international community has increasingly focused on the soundness, safety and resilience of the post-trading infrastructure when assessing the strengths and vulnerabilities of the financial markets in various countries.

In an effort to provide an adequate response to these issues, the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) set up a joint group in order to adopt common standards on securities clearing and settlement systems in the EU. These standards would be the adaptation into the EU of the corresponding recommendations adopted in 2001 and 2004 by CPSS and IOSCO.

The ESCB-CESR work discovered a number of difficulties which have prevented the conclusion of the work so far. Recently, a compromise solution seems to have been reached that could unblock the whole process, one of which is that the "standards" will become "recommendations". Work is expected to be finalised during 2008.

One important aspect of both the ESCB-CESR draft recommendations and the CPSS-IOSCO recommendations is the importance they give to the soundness, the coherence and the

transparency of the legal framework underlying the operation of systems and the protection of customers' securities (recommendations 1 and 12 for securities settlement systems).

In that context, the draft ESCB-CESR recommendations provide that the reliable and predictable operation of a securities settlement system also depends on the laws, rules and procedures that support the holding, transfer, pledging and lending of securities and on how these laws work in practice. If the legal framework is inadequate or its application uncertain, it can give rise to credit or liquidity risks for system participants and their customers or to systemic risks for financial markets as a whole.

For this reason, ESCB-CESR recommend that in addition to the need for legal systems to demonstrate internal coherence and transparency, it is necessary, for systemic risk purposes, that the relevant public authorities support the harmonisation of rules so as to minimise any discrepancies stemming from different national rules and legal frameworks.

1.4 Linkage with global initiatives

1.4.1 Unidroit draft Convention

The work on Barrier 13 is closely neighbouring the work of the International Institute for the Unification of Private Law (Unidroit) which equally works on substantive legal rules regarding securities held through securities accounts. Unidroit is an international organisation with a membership of 60 Member States and has a consensus-based working method. Its Conventions require ratification and implementation by contracting countries.

The Unidroit draft Convention in its current version (Doc. 94)[31] addresses basically a set of issues which is similar to the coverage of the work on Giovannini Barrier 13.

The material intersection between both projects is evident. The *Advice* of the Legal Certainty Group on Barrier 13 addresses probably around 70% of the issues covered by Unidroit and, inversely, nearly 100% of the Barrier 13 issues dealt with by the Legal Certainty Group are in one or the other way included in the Unidroit draft. The future Unidroit Convention, as instrument of international public law, would rank above the EU harmonised legal framework provided that it is ratified by the EU and its Member States. Therefore, both projects cannot be entirely disconnected and conflicts should be avoided to the greatest possible extent. However, at present, both projects are still work in progress. Consequently, despite the general agreement that so far the work on the present *Advice* and the text of the Unidroit draft Convention are largely compatible, a definite answer can only be given at a later stage.

It is worth mentioning that compliance with the Unidroit draft Convention is not a formal requirement for the resolution of Barrier 13, as the Giovannini Barriers exclusively relate to obstacles for the post-trading environment *within the EU*. Thus, formally, Barrier 13 would be eliminated by the effective implementation of a harmonised framework between the EU Member States. However, it is clear that today's global financial markets would ideally be supported by a globally compatible legal framework for clearing and settlement of securities. Given the close ties with the US, the Japanese, the Swiss and other developed markets, as well as the foreseeable rise of markets like China, India and Brazil, global harmonisation should be a common aim of all EU Member States. Therefore, best efforts should be made to

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[31] Preliminary draft Convention on Substantive Rules regarding Intermediated Securities, Unidroit 2007, Study LXXVIII Doc. 94, www.unidroit.org/english/publications/proceedings/2007/study/78/s-78-94-e.pdf, (hereinafter "Unidroit draft Convention").

keep the future legislative action based on the present *Advice* and the future Unidroit Convention compatible.

A Diplomatic Conference on the Unidroit draft Convention will be held, on invitation by the Government of Switzerland, in September 2008. Most EU Member States are expected to participate, as well as the EU, represented by the Commission. It is worth mentioning that the EU has exclusive competence in those areas that are covered by pre-existing Community legislation, in particular the Settlement Finality Directive and the Financial Collateral Directive. In other areas of the Unidroit instrument, legislative competence remains with the EU Member States as long as the Community has not exercised its competence in these fields. A huge portion of the substance falls within the competence of the EU Member States, as the EU itself has not yet exercised its competence in this field. This might happen in the future, for example, if the present *Advice* is followed.

As the Unidroit instrument is designed as an international Convention, it will not be sufficient for Contracting States to agree on the text. To come into force, signature and ratification by a minimum number of States will be necessary, each of them following the relevant rules of its Constitution. To effectively produce positive results, a "critical mass" of countries will not only have to ratify but also to implement the Convention text into the domestic body of law. This process might take several years.

1.4.2 Conflict-of-laws and the Hague Securities Convention

The text of the Hague Securities Convention[32] was adopted in December 2002. So far, the US and Switzerland have signed this international treaty. The instrument contains a pure conflicts-of-law rule that is intended to establish a universally applicable regime which determines the applicable law for proprietary and related rights resulting from the holding, acquisition and disposition of book-entry securities. Thus, the Hague Securities convention mirrors the work on the substantive law side under the label of Barrier 13. Pre-existing European rules, notably Article 9 of both the Financial Collateral Directive and the Settlement Finality Directive, establish equally a conflict-of-laws rule; however, these rules apply different criteria and are therefore incompatible with the method included in the Hague Securities Convention.

The discussion on how a conflict-of-laws rule should be shaped and whether one of the different approaches is preferable is not part of the present *Advice*.

1.5 Linkage of future legislation to regulatory powers

Some aspects regarding the holding and settlement of securities through securities accounts are already addressed by regulatory rules or recommendations on a national, EU and international level (*cf.* section 1.3.2, *supra*). Having regard both to aspects of preserving the stability of the financial system and the protection of investors alike, the authorities competent to deal with these matters, from a prudential supervision and oversight perspective, are shaping the regulatory environment in which settlement activities are being performed.

In this respect, however, uncertainty arises from the sometimes unclear borderline between regulation and legislation. This underlines the need for a clear statement with regard to the preservation of regulatory powers, in particular to the extent that they aim to achieve goals

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[32] Convention on the law applicable to certain rights in respect of securities held with an intermediary, adopted under the auspices of the Hague Conference on Private International Law (hereinafter "Hague Securities Convention").

beyond the legal certainty towards which this *Advice* is aimed. There needs to be clarity regarding which regulatory measures would still be possible accompanying, complementing or further specifying a future legislation on book-entry securities and how both would interact. In particular, to the extent that certain recommendations in the *Advice* could be perceived as being of a regulatory nature (e.g., those related to the execution of client instructions), it should be explained how, if at all, these rules could be specified or even abrogated, e.g. for reasons of systemic stability. This point is crucial for the perception and understanding of future legislation.

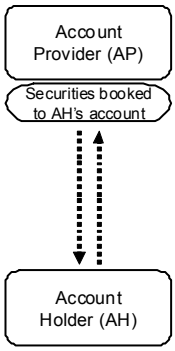
However, the borderline and the specific parameters of where and how substantive legislation would limit regulatory powers are difficult to identify in a general manner. One indicator might be the conclusiveness of a legal rule and whether it does leave room for regulatory intervention or not. A good example is the duty of account providers to hold sufficient securities (*cf.* Recommendation 9): the content of this provision is of a rather regulatory nature; indeed, questions regarding concrete arrangements on who is responsible for the implementation of such a duty, and what would be the consequences of non-performance, are sensibly left to the framework under which the competent regulator operates. As this example shows, there is a need for individual assessment on the limits to regulatory powers set by future harmonised legislation.

Recommendation 2 – Core elements and terminology

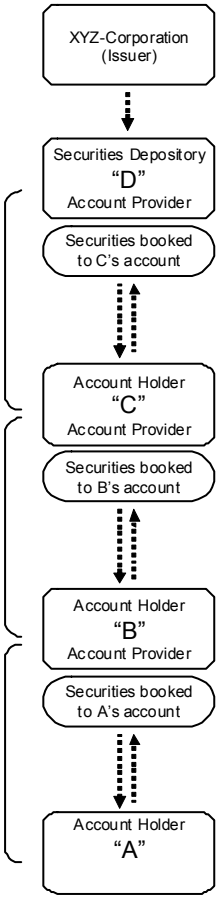
EU legislation should recognise that today's securities holding systems operate through the relationship between account holder and account provider and book entries in securities accounts. However, this is without prejudice to any link between investor and issuer. A further fact is that there may be one or more account providers involved in a chain of holding.

The present *Advice* is based on the idea that account holders hold securities with the assistance of account providers, for which purpose an account provider keeps an account in favour of the account holder to which the securities are credited.

2.1 Holding pattern



Account providers are considered entities like banks, brokers, central banks, central securities depositories and similar, whereas any natural or legal person could be an account holder. In other contexts, reference is made by using other expressions for both the account holder (in particular: investor, customer, client) and for the account provider (in particular: intermediary, custodian). The terms of account holder and account provider appear to be particularly functional and neutral with respect to underlying legal ideas. All modern holding systems are built on the idea of holding securities through account providers. In some systems, only one single account provider intervenes in the holding of securities, 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.



In the case of holding of securities through a holding chain, where more than one account provider intervenes between the issuer of securities and the investor in securities, the entities "in the middle" have a double role: on one hand they are account providers for their own customers down the chain, on the other, they are account holders with respect to their account provider further up the chain. In the example, the holding chain consists of three sets of the basic pattern (*cf.* brackets) each comprising one account holder and one account provider.

It is important to note that the above considerations exclusively relate to how the holding of securities is organised in practical terms, without prejudice to the legal concept underlying the holding, in particular the question of who has any legal rights in the securities (*cf.* section 4.1, *infra*).

2.2 Securities

The present *Advice* uses the term of "securities" in a very broad manner, comprising in particular financial instruments other than cash, like shares in companies or similar entities, bonds or other form of securitised debt, depository receipts in respect of both shares and bonds or any other instruments giving the right to acquire or sell shares or bonds (thought the a clear delimitation between securities and derivatives has not been found yet). Such financial instruments are covered as far as they are capable of being held, acquired and disposed of by crediting and debiting a securities account.

2.3 Securities Account

2.3.1 Distinction from other records

A generic concept of "securities account" is difficult to capture. The notion could be understood in various ways, for example as referring to an agreement between the account provider and account holder, or as pointing to a technical means of book-keeping evidencing rights of the account holder. Even more complicated, it is agreed that account providers use various records where holdings of account holders are included, most of them for technical internal purposes. Thus, a common understanding of the notion of securities account is necessary. Against this background, the notion of securities account should be understood in a *functional way following business practices and being based on the relevant rules of the national legal framework.*

As soon as it comes to identifying the securities account, as opposed to other records which might relate to the same assets held for an account holder, the securities account is the record under an arrangement between account holder and account provider that they regard as decisive in respect of any legal and practical issues that might occur between them.

Consequently, records kept by centralised technical infrastructures or a company registrar are not securities accounts in the sense of the present *Advice*.

2.3.2 Neutrality as to concept of securities account

The future legislation should not interfere with existing market practices regarding the operational and legal structure of securities accounts. It should apply to all techniques of holding by means of book entries.

Consequently it relates to both individual accounts and omnibus accounts. Equally, it does not prevent the direct holding of securities of an investor with an issuer, without the involvement of account providers. The holding through so-called transparent systems should equally be included in the new legislation (*cf.* section 2.5, *infra*).

2.4 Account Provider

In many EU Member States, account providing (by banks, brokers, CSDs, ICSDs and similar) is traditionally subject to regulation and authorisation by a competent authority comprising both authorisation and supervision of the activity.

The background is that investors are generally bound to hold securities through account providers. Consequently, investors can access the legal and economic value of shares and bonds only if account providers maintain sufficient coverage of the relevant securities. This element, in combination with the correct fulfilment of additional duties of an account provider, is the linchpin of the current holding model. However, technically speaking,

everybody could hold securities and open “accounts” for others (for example notaries, insurance brokers, investment advisors, etc.).

Against this background, future EU legislation should clarify the role of public authorisation and regulation with respect to the activity of maintaining securities accounts for others. The issue centres on two main points:

- whether all account providers should be subject to authorisation and regulation; and, independently from this question,
- whether the enhanced legal framework could be sensibly applied not only to authorised and regulated account providers but, at the same time, to unauthorised account providers, as far as they exist.

2.4.1 Authorisation to provide account-providing services

Member States aim at increasing the safety and soundness of holding through account providers by putting the account provider's activity under the scrutiny of a competent authority. This fact is equally reflected by European legislation in the form of the rules of the MiFID. Account providing 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 as soon as 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. They might in most cases be subject to the rules of the MiFID, banking regulations or similar, but there are also account providers in some Member States which are unregulated.

There is wide support for the idea that the activity of account providing should be made subject to authorisation and regulation by a competent authority and that the "gap" left by the MiFID described above should be closed. However, there may be a need for some limited exemptions from this principle, notably as regards entities that exclusively provide account-provider services to a parent company.

This impression is confirmed by the fact that there are similar requirements in the context of neighbouring EU legislation: credit institutions and E-money institutions have to obtain prior authorisation for their activity, under Article 6 of the Directive on Credit Institutions and Article 1(4) of the E-Money Directive. Equally, payment institutions need to be authorised as such, under Article 5 of the Payment Services Directive.

2.4.2 Application of harmonised legal framework to unregulated account providers

A more controversial issue relates to the question of whether the future legislation on the legal effect of book entries can sensibly be applied to account providers that do not operate on the basis of an authorisation by the competent authority. Even if future European legislation were to make authorisation obligatory, unauthorised account providers could still participate in the holding and settlement of book-entry securities, for example in the following scenarios:

- a person or entity provides account-providing services while (intentionally or unintentionally) disregarding the requirement for authorisation; or
- a previously existing authorisation is withdrawn by the competent authority; or

- a person or entity which is part of a holding chain but not subject to the law of any Member State and provides account-providing services to other parties in the chain which are subject to the law of a Member State.

There are good arguments in favour of both possible answers to the question of whether the activity of non-authorised account providers should fall within the scope of future harmonised legislation on book-entry securities.

Arguments in favour of extending the scope to such account providers are based on the following major trains of thought –

- protection of the account holders: the effects of the new legislation will particularly materialise in the event of the insolvency of the account provider. In this case, its client (the account holder) needs effective protection against the loss of its holdings. It would be counterproductive to deny the better degree of protection exactly when the account holder needs it most.
- cross-border connectivity: the future reinforced protection of the position of account holder can only be entirely effective if it is applied throughout the entire holding chain. The participation of account providers who are "in the middle" of a holding chain, and who maintain accounts which are not covered by the future legislation, might affect holdings at a lower tier. This point is particularly important as regards EU-non-EU mixed holding chains with a high probability that one or more account providers subject to the regime of a third country are required to be authorised under EU legislation.
- uniformity of application: both authorised and unauthorised account providers, from a functional point of view, provide identical services and enter into similar types of agreements with their clients, etc. Therefore, it would be unnatural to link different civil-/commercial-law consequences to the sole fact of whether they are authorised or not. This would create insular legal situations and render the environment more complicated than necessary.

Arguments against extending the scope of future book-entry legislation to non-authorised account providers centre on the following considerations:

- There is the question of establishing a level playing field for account providers: if equal legal protection were to result from the fact that non-regulated account providers were covered by the enhanced legal framework, there would be an incentive to use such non-regulated entities since they might benefit from the competitive advantages of not having to bear the regulatory costs.
- From an insolvency point of view there are questions of extending insolvency privileges beyond the narrow scope of regulated financial entities. One might think of the rules of insolvency law which would be partly altered by future legislation: the question is whether the inclusion of non-regulated account providers in the scope of the new legislation would result in undue discrimination towards third parties (other customers, creditors of the unauthorised account provider).
- Problems may arise in relation to the delimitation of activities that would fall under the new harmonised regime and those which would not, particularly if the concept of account provider and securities account were to be defined in rather open terms.

Against this background, and taking into consideration that future harmonised legislation on the effect of book entries to securities accounts should seamlessly integrate into the general legislative and regulatory body of EU law, the future EU legislation will have to take a clear position on the above issue based on a policy decision by the legislator.

2.5 Specificities of "transparent systems"

Under the terminology developed by delegations to the Unidroit project, some holding systems are called "transparent". This notion describes, roughly speaking, a situation where a CSD, in legal terms, maintains separate securities accounts for the individual investors. This is the case for example in Finland (circa 1.1 m accounts in the CSD), and Greece (circa 1.2 m accounts in the CSD) but also outside the EU (for example in China, circa 140 m accounts in the CSD). It is important to note that systems are not necessarily transparent in an integrated manner; some parts can be transparent and others not. Therefore, it is more precise to term a specific part of a holding chain as being transparent.

It is obvious that the day-to-day administration of these accounts cannot be ensured by the CSD itself. To this end, specific entities, often called "account operators", intervene to operate these accounts, i.e. the role of account providing is somewhat split between the account provider (=CSD) and the account operator. The future legislation should fully recognise this split. Therefore, in this *Advice*, references to the account provider should be read to include also or, as the case may be, exclusively an account operator in a transparent holding pattern.

For the most part, the rules developed in this *Advice* apply smoothly and without further difficulties to such situations. However, in the context of some of the Recommendations (notably 3, 4, 9 10, 12 and 14 in particular, *cf. infra*) the split of the function of account provider necessitates specific attention.

In the structure described above, the account operator regularly concludes the account agreement with the account holder and provides services in this respect. The account operator typically makes entries in securities accounts that are maintained by the CSD, according to instructions given by the account holder to the account operator. The account holder neither concludes agreements with the account provider (=CSD) nor gives instructions to the account provider. The account holder is dependent on assistance from the account operator as regards the exercising of rights relating to the securities credited in the account. In addition, the delivery of dividend payments may have been entrusted to the account operator, in which case the account holder cannot direct a claim against the CSD in its capacity as the account provider. Furthermore, the account operator may be responsible, *vis-à-vis* the account holder, for any errors or omissions in making entries in the account holder's securities account, whereas the CSD would not have this liability. Therefore, it is often the account operator that fulfils relevant tasks and has liability even if the securities account is maintained by the account provider (=CSD).

Recommendation 3 – Core role of account providers

3.a In an environment of holding and settlement of securities through account providers, the protection of the rights of account holders as well as the ability to ensure the continuity of the relationship between the issuer and the investors depend heavily upon the careful and diligent exercise of a number of duties by the account provider.

3.b Member States' law should reflect that

- safeguarding book-entry securities;
- following instructions exclusively in accordance with the account agreement;
- processing corporate actions to the extent provided for by the account agreement and the applicable law; and,
- reporting on securities movements and holdings in a manner, with a scope and regularity as prescribed by the account agreement and the applicable law

constitute core duties of any account provider in that respect, in addition to any duty to fulfil any other obligation that might arise under the account agreement or the applicable law.

3.c Account providers should not be allowed to exclude their liability for wilful misconduct or gross negligence in the performance of these core duties.

The explanations under Recommendation 2 have given a first idea on the central role of account providers in holding and settlement of securities: they maintain the accounts and are natural part of any acquisition or disposition of securities with respect to an account. Furthermore, their assistance is vital for the performance of the rights and obligations that exist mutually between an issuer and its investors.

This is true for the great majority of securities holdings. The only exceptions are such securities the holding pattern of which is outside the scope of the present *Advice*, notably securities which are directly and exclusively registered with the issuer, and bearer securities where the certificate actually remains in the hands of the investor or are in separated safe custody with another person.

3.1 Diligence

Against this background the account provider should perform the obligations arising from the applicable law and the account agreement with due care. It should act honestly, fairly and professionally in accordance with the best interests of the account holders and should take reasonable steps to ensure continuity and regularity in the performance of its obligations (*cf.* Articles 19(1) of the MiFID, 5 of the MiFID Implementing Directive). The account provider should employ appropriate and proportionate systems, resources and procedures. It should also apply sound administrative and accounting procedures, internal control mechanisms and effective control and safeguard arrangements for information processing systems. The account provider should implement procedures and arrangements which provide for the prompt, fair and expeditious execution of the orders of the account holders.

3.2 Core duties as identified by the present Advice

The standard of diligence described above applies to all obligations performed by account providers. The Recommendations of the present *Advice* contain a number of core duties in this respect, notably in the following context:

- First, account providers must effectively safeguard clients' book-entry securities (*cf.* Articles 16-17, 47 of the MiFID Implementation Directive). This duty comprises the correct making of book-entries to securities accounts (*cf.* Recommendation 5), and the proper handling of reversals (*cf.* Recommendation 6). However, in the first place, an account provider must ensure that it holds sufficient securities to cover the aggregate number of securities credited to clients' accounts, and that in case of the occurrence of an imbalance the appropriate remedies are applied as quick as possible, avoiding loss of clients' securities or cost to be born by them (*cf.* Recommendation 9).
- Second, account providers must act diligently in following the instructions of the account holder or any other person entitled to give instructions under the account agreement (*cf.* Articles 22 of the MiFID and 47 of the MiFID Implementation Directive, and Recommendation 10);
- Third, account providers must act diligently in the process of making possible for their account holders the exercise of rights flowing from securities (*cf.* Recommendation 14).
- Lastly, an account provider must act diligently in reporting to its clients on securities movements and holdings in a manner, with a scope and regularity as prescribed by the applicable law (*cf.* Articles 19 of the MiFID and 32, 40, 43 MiFID Implementation Directive).

In addition to these core duties, other duties of the account provider arising under the applicable law or the account agreement in accordance with the applicable law must be performed with the same degree of diligence.

Account providing is a privately offered service with terms that are in principle freely negotiable. Therefore, Member States' law should set a framework under which the above duties can be specified by the account agreement. In cases where the account holder is a consumer, EU legislation on unfair terms in consumer contracts applies, in which case unfair terms used in a contract concluded with a consumer (inclusive of unfair limitations) by a seller or supplier shall, as provided for under their national law, not be binding on the consumer.

3.3 Limitation of liability

The requirement to act according to professional diligence should not be circumvented through contractual clauses which unduly limit liability. In a number of EU jurisdictions, liability cannot be excluded or limited, in others such limitations may be challenged on the grounds of lack of reasons, abuse. In cases where the account holder is a consumer, the Directive on unfair terms in consumer contracts applies.

The present *Advice* proposes that, without prejudice to the above cited Directive on unfair terms in consumer contracts, account providers should not be allowed to exclude their liability in the performance of these core duties for wilful misconduct and gross negligence.

However, a proposal for a minimum harmonisation of the liability regime must distinguish between own liability of the account provider and the liability for actions of third parties (in particular upper-tier account providers), in which case liability may for instance be limited to the proper selection of the upper-tier account provider.

Recommendation 4 – Book-entry securities

4.a The law of the Member States should confer upon account holders a legal position in respect of securities credited to the account holders' securities account which includes the following rights:

- first, to exercise and receive the rights attached to the securities (e.g. voting rights, dividends), as far as the account holder itself is entitled to these rights under the applicable law;
- second, the right to instruct the account provider to dispose of the securities;
- third, the right to instruct the account provider to arrange for holding the securities in a different manner, i.e. holding them either with another account provider or otherwise than with an account provider, as far as permitted under the applicable legal framework.

4.b The conceptual nature of the legal position (e.g., property right, or other) should be left to the national law.

4.c In case of a security interest or other limited interest the applicable legal framework can restrict the above set of rights, for example exclude the right to receive dividends or the right to dispose of the position.

4.d The legal position which is thus harmonised in its minimum content should be described by a common notion. The present *Advice* uses the notion "book-entry securities".

4.1 Background

The most relevant aspect of the future European legislation 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, *cf.* Recommendation 5 and Recommendation 6, *infra*.

However, the certainty that an account holder acquires such position must be accompanied by a specification regarding the content of the acquisition. This is because account holders need to be sure to what extent the acquired position can be used for economic purposes: 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 its obligations, etc.

The legal design of the position must provide clarity regarding these elements. To this extent, there is a clear need for harmonisation. However, it appears that the *exact legal-conceptual nature* of the acquired position is only of secondary importance to the acquirer, under the condition that the above aims can be achieved under this legal position. Consequently, it is crucial that harmonised European legislation provides for a mechanism which, in a cross-border context, gives a clear answer on the legal attributes relevant to its adequate use. Such mechanism should be the setting of a minimum content which a legal position attributed to an acquirer by the national law must have.[33]

[33] A further reaching approach, which is not taken by the present *Advice*, is to establish by the new legislation that book-entry securities are a new class of legal asset which is disconnected from the context of the domestic legal framework. Some consider that only this option could properly eliminate the legal uncertainties that had been identified under the label of Barrier 13. However, implementation of such concept would be complex, taking a very long time to fully explore its systematic effect in the various EU jurisdictions belonging to different legal traditions and contemplating clearly differing holding patterns. Such approach might merit being explored in the future, depending on the evolution of the EU's securities markets.

When analysing the legal position under national law, in the first place, an important distinction has to be made: under national corporate law and other relevant laws, a securities holder has a specific legal position. However, in some (not all) Member States, this legal position might change depending on whether such securities are credited to a securities account or not. This phenomenon occurs in particular in the context of holding systems which are built on the issuance of a paper certificate which is subsequently immobilised with the CSD: supposing the investor had the paper certificate physically in his hands or held in segregated safe custody under his name, he would enjoy exactly and purely the full legal position with respect to the securities given by the applicable law (in most countries "ownership" or "property"). In case the paper is delivered into the holding system the legal position would change in many jurisdictions, for example towards a shared property interest in a pool of securities or similar interest, or the equitable interest of a trustor (investor) against the trustee (account provider). Consequently, it would be unwise to start from the understanding that account holders have necessarily in all jurisdictions "securities" in their accounts. Accordingly, the term of "securities" should be used in this *Advice* exclusively for the underlying, "original" legal position and not for describing the legal position that an account holder receives when those securities are credited to its account.

The above raises the question of what is the exact legal position received by an account holder upon credit of securities to its account under national law. The answer is again that there are significant differences depending on the law of the Member States. Under national law, two factors can have influence on the legal position of an account holder when securities are credited to his account: first, the basic legal concept, and, second, the question whether the account holder holds for its own account or for the account of somebody else.

First, the basic legal concept differs considerably between the various Member States: some systems are based on the principles of property law. Others organise the holding and disposition of securities following the concept of fiduciary trust. In a third group of jurisdictions, securities holding and transfer is based on legal ideas specifically developed for such holding methods (legal concept "sui generis").

Second, in some jurisdictions, it makes a difference whether an account holder is the one at the end of the holding chain that holds for its own account or whether the account holder does not hold for its own account but for another person. In such system, this factual difference leads to a completely different analysis regarding the legal position of the account holder. For example, under German law, the "ultimate account holder" has a shared property interest in a pool of securities kept by the CSD, whereas account providers which are also account holders in the holding chain have no proprietary interest in the securities but have merely a role of safe-keeper with actual or deemed possession of the securities,. In the UK (England and Wales), the upmost account provider (which is the participant in the CSD in this case) is regarded as trustee having legal ownership of the relevant securities, while the ultimate account holder has the role of a trustor with respect to the securities, disposing of an equitable interest in the securities, as opposed to legal ownership. All entities intervening in the holding

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The key element of such approach would be the introduction of a new class of legal assets in all Member States' jurisdictions, which could be called for instance *securities entitlement* by analogy to the similar legal concept introduced by Article 8 of the US Uniform Commercial Code: a derivative legal asset distinct from the underlying securities and consisting of a combination (bundle or package) of proprietary rights and personal rights. The proprietary component protects the holder from the credit risk of all its upper-tier account providers. The personal component is the result of the derivative nature of this new legal asset. While the proprietary component remains unchanged upon the transfer from one account to another, the derivative component varies depending on the contractual arrangement between the account holder and its own intermediary.

chain are themselves trustors as regards their own holding with the upper-tier account provider and trustees with respect to their own account holders.

4.2 The minimum content of the legal position of the account holder

Against the background of the above, future legislation should focus on a harmonised minimum set of legal features of the position of an account holder instead of addressing the issue of its conceptual-legal classification. It should opt for a functional approach which is shaped along the practical purposes of acquiring securities or interests in securities. Notably, account holders need to know (a) that the securities can be disposed of under a sales agreement or used as object of a security interest; (b) whether they can enjoy the rights flowing from the securities (dividends, voting rights), or whether they cannot. Under which legal concept these elements are defined (property, shared property, trust, right *sui generis*) is not decisive.

Therefore, the legal position conferred upon an account by a security credited to its securities account or an interest in securities should comprise at least the following minimum elements:

- the right to receive and exercise the rights attached to the securities (dividends, voting rights, etc.) as far as the account holder is entitled to these rights under the applicable law;
- the right to instruct the account provider to make a book entry on the account for such purpose as to dispose of the securities, to create a security interest over the securities or to create any other limited interest in the securities;
- the right to instruct the account provider to arrange for holding the securities in a different manner, i.e. either holding them with another account provider or holding them otherwise than with an account provider, as far as permitted under the applicable legal framework.

The national law should continue to determine the general conceptual nature of the position of the account holder and can attribute additional characteristics to it as far as they are not incompatible with the above.

4.2.1 Right to receive and exercise rights attached to the securities

In many of today's holding systems the number of *credits of securities* of the same description to securities accounts is actually a multiple of the number of underlying *securities* of that description. This is because of the multi-tiered holding structure where several account providers form a holding chain of the kind described in Recommendation 2, above. The multitude of consecutive accounts between the various participants in such chain leads to a situation where the amount of securities credited to the last person in the holding chain is reflected by credits in all accounts further up the chain.

It is obvious that not all account holders having credits in a holding chain can be entitled to the rights attached to the securities but generally just one single person. This is for two reasons:

- First, any different understanding would put the issuer in a situation where it faces the exercise of a number of rights which does not correspond to the number of securities that have been issued.

– Second, the persons who actually bear the economic risk of an investment in securities must generally be exclusively entitled to the exercise of rights attached to them, without the risk of any degradation by an exercise of rights by other persons.

National law regularly addresses this issue comprehensively by having a clear legal rule on who the entitled person is. When it comes to cross-border holding chains it might well happen that the relevant rules of the involved jurisdictions have a similar understanding and that therefore no difficulties arise. However, there might be cases in which the national law differs as to who should be *legally* entitled to the rights attached to the securities, though the general *practical* understanding of who should ultimately benefit would probably be the same.

4.2.2 Right to dispose of the securities or create an interest therein

The original function of securities was to ensure tradability of the legal position by simple transfer of a paper in which the rights are incorporated. This economic function shall be unaffected by the fact that securities are held in accounts maintained by account providers. Consequently, the credit of securities to a securities account must confer upon the account holder the right to instruct the account provider to make a book entry on the account for such purpose as to dispose of the securities, to create a security interest over the securities or to create any other limited interest in the securities. Any participant in a holding chain, both end-investor and those who hold for others, make use of this right. However, this is without prejudice to the issue of whether an account holder, in particular one holding securities for others, is *responsible* to its own account holder under the applicable law and the account agreement to dispose of book-entry securities exclusively on the basis of an instructions in this regard, *cf.* Recommendation 6.

Disposition comprises three types of changing of the legal situation of the book-entry securities: (a) disposal, i.e. the getting rid of the securities; (b) the creation of a security or other limited interest in book-entry securities; and, (c) the abandoning of a security or other limited interest (*cf*. below, Recommendation 5).

4.2.3 Right to hold the securities in a different manner

Though holding through account providers is standard today, there is no general obligation to hold securities through a specific account provider or through account providers at all. Consequently, the set of minimum rights comprises two elements that enable account holders to move securities away from an account provider:

First, there must be the possibility to hold the securities with a different account provider and an account holder must have the right to instruct the present account provider accordingly.

Second, there should be the possibility of retrieval, where applicable. Retrieval implies exit of the securities from the holding through account providers and from the scope of the relevant legislation. Securities can be retrieved in two manners: first, there might be the possibility, under the applicable law and the terms of the issue, to hold the securities directly with the issuer. Second, as far as they are issued in certificated form, securities can be retrieved by delivery of the paper certificate to the holder.

The possibilities of delivery of a paper certificate are often restricted. This is because, even in case securities are certificated, they might be immobilised: in such case paper instruments or certificates still exist but only in the form of global certificates. Some jurisdictions leave the regulation of the matter to the terms of issuance. Retrieval is often also subject to the law regulating the account provider or even the rules of a securities settlement system. However, it may be discussed whether it is appropriate, in the absence of reasons of public order, that

the law of the account provider may prohibit exercise of the right of retrieval when the law of issue allows it. This may create segmentation within the EU financial market and affect competition since account providers will be able (or not) to perform requests of retrieval relating to the same type of book-entry securities according to the legislation in force in the country of establishment. Similar considerations apply to the question on whether EU legislation should allow the account agreement or the rules of a securities settlement system to restrict the exercise of the right of retrieval if the issuer law allows it.

4.3 Neutrality of the concept

Future EU legislation built on these principles would not aim at any reconstruction or fundamental change to national legal concepts. Rather, introducing the model of harmonised minimum features will lead to harmonisation in the EU countries in the sense that the legal position given to an account holder stems from and remains entirely compatible with the general legal-conceptual approach of securities holding through securities accounts in the relevant jurisdiction. Therefore, the national law can attribute additional features to the legal position described above. For example, where the applicable law qualifies the right of an account holder in book-entry securities as a property right, the legal position will have all relevant features. Furthermore, the legal framework of Member States will continue do determine whether or not a credit to a securities account confers upon an account holder the position of beneficiary of all rights flowing from the securities and what the exact content of a credit to the accounts of other account holders in the holding chain would be.

However, where the legal position which is conferred upon an account holder under national law does not comply with these minimum features or where it is contrary to any other rule of the future legislation designed to support that legal position it will need to be conformed.

4.4 Limitation of the minimum rights in the case of security interests and other limited interests

The above described rights are generally conferred upon account holder as soon as securities are credited to an account. However, there are situations where such crediting occurs, however, it is not the understanding of the involved parties that the receiving account holder shall have the right to exercise voting rights or dispose of the securities or neither of these rights. This is the case in particular where a crediting occurs in the context of the creation of a security interest or another limited interest.

Example 1: X creates a mortgage over his securities in favour of Y. The applicable law requires a crediting of the securities to Y's securities account for this purpose. However, under the applicable law, the beneficiary of a mortgage (here: Y) shall not be in a position to dispose of the book-entry securities nor shall he receive the dividends.

Example 2: M creates a usufruct over his securities in favour of P. Under the applicable law, this requires crediting of the securities to P's account. According to the applicable law (and the parties understanding), P shall receive the dividends, however, he shall be unable to vote at the general meeting of the company or to dispose of the book-entry securities.

The issue of which types of dispositions should be available under a harmonised regime is addressed under Recommendation 5; the basic rule says that only the *method* (for example: crediting) needs to be harmonised whereas the *legal nature* of the disposition (pledge, mortgage, charge, usufruct, etc.) can be left to Member States' law. Consequently, Member States' law must have an influence on the content of an acquired position. In particular, in the context of security interests and other limited interests, the law must be in a position to restrict the security taker's right to dispose of the securities and to restrict the right to exercise rights flowing from the securities.

From a practical point of view, some voices have raised concerns that credits that were made in order to create a security interest (for example a pledge) were mistaken for credits which confer upon the account holder the "full" right, as for example under a title transfer security agreement. Such credits would need to be specifically identified, for example by adding a specific earmarking or taking other operational measures, in order to ensure that the terms of the security interest were respected, also in order to avoid that such credits led to an inflation of the number of securities. Similar considerations applied to other limited interests, such as usufruct.

However, most perceive this openness as an advantage, *cf. infra*, section 5.2.2: it is of no importance for the effectiveness of a security interest whether the credit is intended to convey the "full" or only a "limited" legal interest: the account holder would in any case have the certainty that an effective security interest has been established. The actual legal content of the right conferred upon the account holder (security taker) by the credit would be determined by the security agreement under the applicable law; there was no reason to make the account provider guardian of the relationship between account provider and account holder.

4.5 The term "book-entry securities"

For purposes of practicality, when elaborating on the system on how the legal position of the account holder as set out above is acquired, disposed of, encumbered and legally protected (*cf.* Recommendations 5 to 11), it should be given a common notion. This notion could not be the term "securities" because, as explained above, the term securities has a precise legal meaning under the corporate law of each and every jurisdiction to which the legal position of an account holder does not necessarily correspond. Therefore, the present *Advice* uses the notion "book-entry securities" to describe the legal position. The expression "book-entry securities" is intended to be neutral between the ranges of legal approaches, and is not intended to favour any one of them.

A variety of expressions has been discussed both in the Legal Certainty Group and in the context of other initiatives: "indirectly held securities", "securities held with an account provider" and "intermediated securities" have been considered as not being sufficiently neutral. The Legal Certainty Group basically discussed whether "book-entry rights" or "book-entry securities" would be the better notion. "Book-entry rights" offering on one hand the highest degree of neutrality but risking not to give sufficient guidance to the unprepared addressee, "book-entry securities" seems to be the best compromise. A further variety would be the expression "account held securities" or "book qualified securities" which appear to equally fulfil a sufficiently high degree of neutrality. Again, it is important to note that this notion does not represent a legal concept but is just a cover for the above described legal positions under Member States' law, designed to facilitate drafting and communication.

Recommendation 5 – Effectiveness of acquisitions and dispositions of book-entry securities and interests therein

5.a Future EU legislation should require Member States' law to recognise acquisitions and dispositions which are rendered effective by one of the following methods:

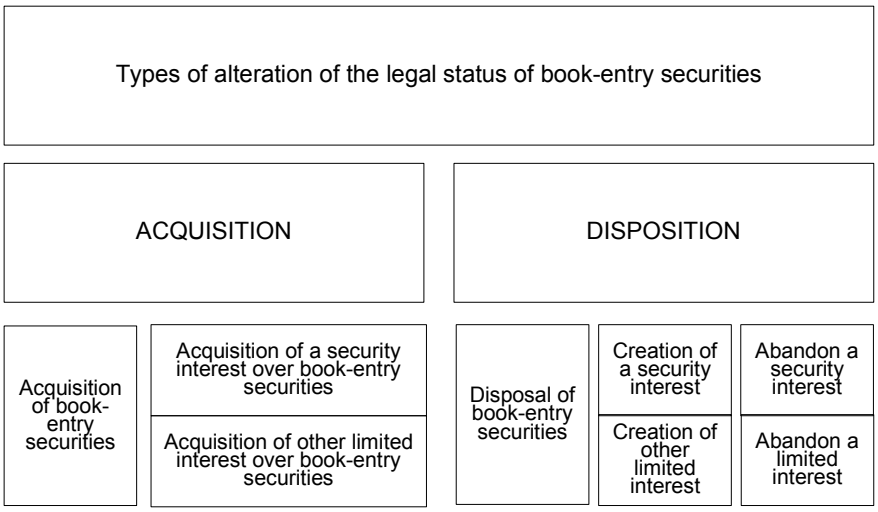
- crediting an account;
- debiting an account;
- earmarking book-entry securities in an account, or earmarking a securities account;
- concluding a control agreement;
- concluding an agreement with and in favour of an account provider.

5.b The above methods prevail over any other method permitted by the applicable law.

5.c Acquisitions and dispositions arising by mandatory operation of law are effective and have the legal attributes, in particular rank, following the provisions of the applicable law.

5.1 Background

The central focus of future legislation will be a harmonised framework for acquisition and disposition of book-entry securities. The notion of acquisition and disposition is commonly used for describing the entire set of possible alterations of the legal situation of book-entry securities standing to the credit of an account:



Terminology: (1) Acquisition means the receiving of book entry securities, with the additional legal attributes depending on the legal system. It refers equally to the receiving of a security or other limited interest. (2) Disposition comprises both the creation of a security or other limited interested in favour of another person and the disposal of book-entry securities. (3) Disposal of book-entry securities means getting rid of them, in particular for purposes of a sale. (4) Security interest comprises all sorts of legal concepts to provide security, in particular to secure a credit. (5) Non-title-transfer security interest refers to the first group of security interests where the security provider retains the book-entry securities and creates only a limited right in favour of the security taker, e.g. under a pledge, a charge or a mortgage. (6) Title-transfer-security interests are security interests involving a transfer of the book-entry securities to the security taker, regularly combined with the

obligation to transfer them back once the security provider has fulfilled its obligations; (7) Disposal of security interest or other limited interest means to abandon it.

This Advice avoids the term "transfer" of securities as it implies the concept of moving securities from one account to the other. This being the correct legal analysis in some of the Member States' jurisdictions, however, in other systems the analysis is different and a traceable link between the transferor and transferee of securities cannot be identified.

"Limited interests other than security interests" refers to legal concepts where account holders encumber book-entry securities in the sense that another person has an own right to use them, for example reap their fruits. The most prominent example is a usufruct, where a person different from the account holder is entitled to receive payments flowing from the securities, in particular dividends. Both creation and abandoning of limited interests are equally referred to as "disposition" of securities. The legal treatment of such limited interests plays only a marginal role in terms of legal certainty related to stability of the system. However, the issue of limited interests other than security interests should be addressed by the future harmonised legislation, as they are generally created by methods that are identical with the methods provided for the other types of acquisition and disposition. Thus, it is possible that at the same time both security interests and other limited interest relate to the same book-entry securities, in which case a rule regarding priority of competing interests must also extend to other limited interests. Consequently, the future legislation should recognise limited interests other than security interests.

5.2 Methods to render acquisitions and dispositions effective

Under the law of the EU Member States a variety of methods for effecting all types of acquisition and disposition is at the disposal of an account holder, some entailing book-entries to the relevant account, others entailing no changes:

- 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;
  - other methods.

However, in the EU, there is complete inconsistency between the various jurisdictions as to the role of these methods. This means that different methods are used throughout EU jurisdictions to realise one or the other type of acquisition and disposition. For instance, in some countries, security interests require an earmarking, in others a crediting to a specific pledge account. In some jurisdictions, more than one method can be used for realising the same effect, for example, in a given jurisdiction, both earmarking and control agreement are suitable methods for creating a security interest.

This very different use of the methods throughout the EU jurisdictions makes it difficult to attribute specific methods to specific forms of acquisition or disposition. It is impossible to state which methods are the most used in particular for the creation of security interests. Consequently, taking an EU-wide view, there seems to be varying application of the above listed methods, plus other less prominent ones, to whatever kind of acquisition or disposition.

Terminology: (1) "Credit" is a positive position in a securities account; (2) "Crediting" of a securities account means the adding of credits to that account; (3) "Debiting" of an account means the subtracting of credits from an account; (4) "Book-entries" comprise the methods of crediting, debiting and earmarking, i.e. all methods which entail a change on the relevant account; (5) N.B, under this concept there is no terminological room for the notion "debit", as the debiting of an account leads to the erasing of credits; (6) "Earmarking" is a technique under which by technical means credits in an account are marked as encumbered which is in most cases also visible in the account statement; an alternative expression is the term designating entry. (7) A "control

agreement" is a contract between the account holder, the account provider and a third person or between the account holder and a third person of which notice is brought to the account provider under which book-entry securities are blocked in the account in favour of the third person, in particular for providing security to that person; (8) An "agreement with and in favour of the account provider" is concluded between an account holder and its direct account provider; the purpose is to confer a legal position upon the account provider, in particular a security interest, which it can easily realise as it has complete control over the account; insofar, the reasoning behind this constellation very much resembles the control agreement; (9) "Other methods" available under national law are probably all non-book-entry methods, e.g. a simple agreement (without any additional element) between transferee and transferor by which means securities are disposed of and acquired, or encumbered.

5.2.1 Neutrality as regards the legal concept of acquisition and disposition

It is important to analyse how the application of these methods relates to underlying legal concepts of the law of the Member States. The underlying legal concepts for acquisition and disposition differ considerably amongst EU Member States' jurisdictions as regards requirements for effectiveness between the parties of acquisitions and dispositions and *vis-à-vis* third persons.

For example, the acquisition of book-entry securities is based, in several jurisdictions, on the rules on transfer of property, whereas in other jurisdictions, rules on assignment are applicable. As regards the creation of security interests, a sheer unlimited variety of legal concepts is used throughout Member States, in particular pledge, legal or equitable mortgage, repo, fixed and floating charges, etc. It is worth noting that even if legal concepts of two or more jurisdictions are termed the same way they most probably differ at least regarding the details of their legal requirements. The future harmonised legislation, by building on the above methods for acquisition and disposition, acknowledges that harmonising the underlying legal concepts is neither necessary nor possible in order to achieve a sufficient level of consistency.

The harmonisation of *methods* for acquisition and disposition of book-entry securities is a much less intrusive approach which enables national jurisdictions to stick to established legal concepts. Thus, assignment, transfer, pledge, mortgage, repo, floating charge, etc. could still be used in each jurisdiction. Harmonisation would only happen on the level of the factual requirements of each and every legal concept. This means that the legal concept must require one of the above listed methods in order to render the acquisition or disposition effective and must not require any additional elements.

Example 3: In Member State A, acquisition and disposition of book-entry securities are possible under two different methods: either by debit and credit to the relevant securities account, or by simple agreement between the parties. The first method would be compliant with the future legislation. The second method would not be compliant.

Example 4: In Member State B, security interests over book-entry securities are created under the legal concept of pledge. The pledge requires the debiting of the securities in the pledgeor's account and the crediting to the special pledge account in the name of the pledgee. As the pledge is constituted by credit and debit, this method would be compliant with the new legislation.

Example 5: In Member State C, security interests are created as a mortgage, requiring the debiting of the securities to the security provider's account and their crediting to the account of the security taker. Additionally, a filing with a public register is necessary. Here, the elements of credit and debit would fit with the future legislation. However, the filing with a register must not be required.

Example 6: The law of Member State D establishes pledge as applicable concept for providing security over securities. At the same time, repo arrangements are used by the market to secure obligations. This would be perfectly possible under the new legislation, provided that the transfer of book-entry securities under the repo agreement would use one of the above methods, for example debiting and crediting of book-entry securities.

5.2.2 Catalogue of methods available under the harmonised legislation

At first glance, some of the above methods appear to apply in a more natural way for one or the other form of acquisition or disposition. In particular, the most obvious methods for the acquisition and disposal of book-entry securities are the crediting and debiting of securities accounts. However, already when it comes to the creation of security interests, none of the methods set out in section 5.2 seems to be preferential. All six of them are somewhat rooted in the traditional understanding that the security taker has to gain power over the encumbered asset. This reasoning is equally reflected in the Financial Collateral Directive which states in its Recital 9 that the only requirement which national law may impose in respect of financial collateral is that it is "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker".

Therefore, future European legislation should make available the entire catalogue of six methods. Any other approach would be contrary to the principle of neutrality of the future legislation and would probably impede widespread market practices.

Non-book-entry methods other than control agreement or agreement with and in favour of the account provider remain, however, excluded from the catalogue of harmonised methods (example: simple agreement between an account holder and another person aiming at transferring the book-entry securities to that other person). This is because of the fact that such methods have no connection to a securities account.

5.2.2.1 Acquisition of book-entry securities *vs.* creation of security interest

A second important point is that the market uses both title-transfer and non-title-transfer security interests. No jurisdiction within the EU prescribes different methods for outright transfer of book-entry securities depending on whether or not they are being transferred for purposes of providing collateral nor would it advocate such a distinction. The borderline between methods for the creation of security interests and methods used for the outright transfer under a sale becomes blurred against this background. In the end, only details of the concrete legal terms of the agreement and the underlying national law decide whether the full right or only a limited interest was transferred under a security agreement, whereas the operational steps could be indifferent in this regard.

Consequently, there should be no distinction in the sense that the methods of crediting and debiting are being used for acquisition and disposal of book-entry securities and all other methods fit for the creation of security and other limited interests.

5.2.2.2 Book-entry and non-book-entry methods

Crediting, debiting and earmarking of an account are based on the idea that technical changes to the account occur as soon as such book entry is made. Consequently, an acquisition or disposition under a book-entry method leaves "traces" in the account which are perceivable to the account provider and the account holder, for example because they appear on an account statement. By contrast, control agreements and agreements with and in favour of the account provider do not entail book entries in the account.

This fact provokes the question of whether non-book-entry methods are less certain and should therefore not form part of the catalogue of methods available for effecting acquisitions and dispositions under a harmonised legal regime. The discussion focuses in particular on the method of earmarking *vs.* the method of control agreement. Both consist basically of a tripartite agreement between the account holder, the security taker and the account provider. The agreements have in both cases a similar content that is that the securities in the account

are blocked in favour of the security taker. Only, the method of earmarking adds an additional element, notably the visibility of that status within the IT system of the account provider.

However, the account provider is the only person having control in a technical sense over the securities account. As long as it observes the agreement with account holder and security taker there are no doubts about the certainty of the security arrangement. An account provider would have technical procedures in place to guarantee the blocking; for these procedures it should be irrelevant whether there is an earmarking in the account or elsewhere in the account provider's technical infrastructure. A third person, in particular a security taker would need to have access to the account data in order to check the observance of the agreement.

Consequently, the difference between book-entry methods and non-book-entry methods is not such that book-entry methods provide *per se* for more certainty. Certainty depends first and foremost on the reliability of the account provider. Thus, there is no reason to exclude non-book-entry methods from the catalogue of available methods, as they involve the assistance of the account provider to the same extent as book-entry methods do.

5.2.2.3 Other methods

The question of whether there should be and how to handle non-harmonised "other methods" for acquisition and disposition of book-entry securities is closely related to the issue of how a new legislation will relate to existing national property and securities laws.

Creating a system where all relevant rights and interests should use one of the above methods appears to be the right way. As regards the issue whether and to what extent transactions of book-entry securities should be possible applying methods which are not harmonised there are two different potential solutions:

- transactions using other methods have no legal effect. The methods contained in the catalogue are the only ones capable of rendering effective acquisitions and dispositions of book-entry securities, or,
- the harmonised methods are in the first line, whereas all acquisitions and dispositions rendered effective by other methods should have an "inferior rank", i.e. transactions under the new, harmonised solution would always prevail.

On one hand, the share of acquisitions and dispositions using other methods is very small compared to the total number. Acknowledging the persistence of such methods would certainly water down the overall harmonising effect of EU legislation in this field and would, from a conceptual point of view, complicate the implementation of the future regime. On the other hand, there is a certain area where acquisitions and dispositions using other methods can be useful. These conflicting arguments can be conciliated by on one hand generally allowing the use of other methods for acquisitions and dispositions, while at the same time giving priority to acquisitions and dispositions involving one of the harmonised methods in case of a contest of conflicting rights or interests (*cf.* below, Recommendation 8).

5.2.3 Degree of recognition under Member States' law

A further important question is to what extent harmonisation of methods for acquisition and disposition of book-entry securities requires Member States' law to recognise *all six* methods.

A maximum approach would consist in making available all six methods for acquisition and disposition under the law of all Member States. This solution would have the advantage of seamless cross-border compatibility, as all methods would figure in the law of all jurisdictions and could be relied on easily in cross-legal contexts. Such maximum solution bears certain

difficulties: some of the methods are alien to legal traditions of certain Member States. Consequently, they are currently not offered under the national law. However, an introduction of these methods in the relevant jurisdiction might result in important conceptual difficulties entailing changes to legal concepts that are also used in other contexts and therefore producing significant conceptual pollution. On the other hand, it would be insufficient to just align details of pre-existing methods in a given jurisdiction with a homologous method contemplated above without giving the other, not yet existing methods any status of recognition.

Example 7: X holds 1000 securities in an account maintained by Z. He provides a security interest to Y using a three-partite control agreement X-Y-Z. X is located in country A, whereas Y and Z are located in country B. The control agreement is established using the B-law. X falls insolvent, the insolvency rules of A-law apply. A-law does not comprise the concept of control agreement. The insolvency administrator claims that X's security interest is not recognised by the insolvency law of A country and that the securities in the account with Z therefore fall into the insolvency estate without any preferential treatment of Y.

This example shows that there needs to be an element ensuring that legal effects produced under the applicable law using one of the harmonised methods are in all cases recognised in all jurisdictions, an effect which is achieved under Article 9 of the Financial Collateral Directive, which does, however, not apply to all account holders and account providers. Against this, some voices recommend taking a position oriented towards minimum harmonisation by keeping the EU wide recognition of methods for acquisition and disposition of book-entry securities restricted to financial institutions covered by the scope of the Directive. However, most contributors are concerned that such an approach would promote the co-existence of two different legal regimes on book-entry securities.

Thus, the present *Advice* follows the line that Member States insolvency law and other relevant laws will be required to recognise acquisitions and dispositions that have been validly established under the applicable (other Member State's) law. An element still to be considered is whether regulatory rules applicable to an account provider in a jurisdiction not permitting control agreements may be prohibited to enter into such arrangements under a law which permits these types of arrangements.

5.3 Security interests created by mandatory operation of law, in particular mandatory banker's lien

In various EU jurisdictions, there are security interests over securities held in book-entry form which are created by mandatory operation of law. They might be either motivated by considerations of public order or of the stability of the financial system. The most prominent example is probably the banker's lien, a security interest over securities in favour of the account provider the purpose of which is to secure the purchase price of the securities and, depending on the legal details, also other claims of the account provider against the account holder.

Such security interest needs to fit into the overall system of the creation and priority of acquisition of book-entry securities and limited interests in book-entry securities. Given the variety of concepts and the lack of need for a harmonised rule in this regard, issues of rank *vis-à-vis* interests created by one of the methods described above could be entirely left to the national law, *cf. infra,* section 8.3.4.

A different issue is the contractual banker's lien which occurs on the basis of a contractual agreement, in particular included in the general terms of the account agreement. The important difference is that there is no conceptual difference between such a lien and any security interest created by one of the harmonised methods described above. Consequently, questions of the protection and the priority of such security interest depend first and foremost on the method chosen. An additional aspect is a possible alteration by contract: given its nature, a contractual banker's lien will nearly always be first in time, i.e. it nearly generally would rank first. However,

the rank of a contractual banker's lien can be changed by contract. This can even be achieved implicitly, in particular in a scenario where a subsequent security interest is created in favour of a third person, involving the assistance of the secured account provider which does reserve its right regarding the lean at the time when the subsequent security interest is created, cf. infra, section 8.3.3.

Recommendation 6 – Effectiveness and reversal

6.a An acquisition or disposition using one of the methods set out in Recommendation 5 should be immediately effective *vis-à-vis* the account provider and against third parties, including the account provider's insolvency administrator and creditors in its insolvency proceedings. No further steps may be required by national law to render the acquisition or disposition effective. Member States' law may stipulate that the effectiveness can be made subject to a condition agreed upon between account holder and account provider.

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

6.c Member States' law should prescribe that book entries can be reversed under the following circumstances:

- in the case of consent of the account holder;
- in the case of erroneous crediting;
- in the case of unauthorised debiting, earmarking or removal of an earmarking.

6.d By means of reversal the reversible book entry is undone, to the extent possible, by the making of a converse book entry.

6.e The national law can 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.

6.1 Background

The Giovannini Reports singled out the absence of common rules regarding the moment of transfer as one of the differences in national law responsible for legal uncertainty. However, the idea that the moment of transfer of rights can be established is very much linked to specific legal concepts. Therefore, harmonisation of this aspect appears particularly difficult from a conceptual point of view. Furthermore, for the safety of acquisition and disposition of book-entry securities, the legal concept of moment of transfer is not so important by itself. Certainty requires first and foremost the assurance that from a certain point in time acquisitions and dispositions can no longer be "undone" and are "good against" third parties. This state is often described by terms like validity, effectiveness, finality, irreversibility, irrevocability, etc.

"Finality": In the context of validity, reference is frequently made to "finality"; however, a clear distinction has to be made between two distinct concepts, which occur at different points in time, (i) the finality of transfer orders/instructions, which are protected from insolvency or other unwinding risks (this is the sole concept used in the Settlement Finality Directive), and (ii) the finality of an acquisition or disposition of book-entry securities. Only the latter concept is of direct relevance for the present analysis of effectiveness of credits and book-entries, however, the finality of transfer orders may become relevant when assessing whether a valid and enforceable instruction has been given to an account provider.

Therefore, this *Advice* departs from the terms of the Giovannini Reports and addresses this important aspect from a purely functional point of view, disregarding the issue of moment of transfer. The analysis centres on the two decisive elements:

First, there is the question on the requirements to be met in order to render an acquisition or disposition effective. The principles set out below apply to both book-entry and non-book-entry scenarios (*cf.* section6.2). However, there is a caveat regarding effectiveness of an acquisition or disposition *vis-à-vis* the issuer (*cf.* section 6.3).

The second question is if and under what circumstances an effective acquisition or disposition can be "undone" and what the legal consequences in such a case would be. However, the rules on undoing differ depending on the method under which the acquisition or disposition had been effected: acquisitions and dispositions effected by book entries, i.e. crediting, debiting, earmarking and removal of an earmarking follow the principles on reversal (*cf.* sections 6.4 and 6.5). Acquisitions and dispositions using a non-book-entry method, i.e. control agreement and agreement with and in favour of an intermediary, are undone following different rules which should be left to national law (*cf.* section 6.6).

6.2 Necessary steps to render acquisitions and dispositions effective

6.2.1 General rule

Under future EU legislation, acquisitions and dispositions should be effective once they are established under one of the methods (book-entry or non-book-entry) set out in Recommendation 5. This establishes, without any further acts,

- the effectiveness between account holder and account provider, i.e. the account provider is generally unable to reverse the acquisition or disposition (for exceptions *cf.* below);
- the effectiveness against the insolvency administrator and the creditors in any insolvency proceeding which might be opened over the account provider;
- the effectiveness *vis-à-vis* third persons, to the extent they can be identified (for example unsecured creditors of a security provider).

6.2.2 Exception: conditional credits

Conditional credits are used in some Member States 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. Conditional book entries are made on the basis of a prior general agreement between account holder and account provider.

Example 8: Account holder X instructs his account provider Y to purchase 100 ABC bonds on the stock exchange. The relevant settlement arrangements provide for a T+2 mechanism. However, Y credits the bonds to X's account immediately on the trade date. The applicable law and the account agreement provide for such credits being made on the condition that the relevant amount of securities is credited to Y's account with the CSD. Until the point in time at which Y receives the relevant coverage, the credit to X's account does not confer any right.

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.

First, this is important because a condition (of whatever kind) cannot be invoked against a person that acquired an interest in the credit position if the condition was not apparent from the account (transparent). If the condition was apparent from the account, the condition should be upheld against the acquirer or any other third party (who should have checked the account and thus should have discovered the conditionality).

Second, in cases where a condition is not transparent from the account, there should be limitations of the right to invoke a condition against third persons, e.g. creditors of the account holder (including an insolvency administrator). This would be relevant e.g. for legal systems which do generally impose conditions on book entries (such as value dates of T+x), without making those conditions transparent from the book entry itself.

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. In this regard, limitations to the right to invoke such non-transparent conditions might ensure adequate information and protection of the account holder itself, but also of third parties relying on the status of the account holder's positions/holdings (provided, however, that the conditionality was not apparent from the general legal and/or operation framework applicable to a system or intermediary).

However, if such non-transparent conditional bookings could be passed down a chain of intermediated holdings into another jurisdiction, a domino effect might occur if the condition does not materialise. In this respect, a possible compromise could be to allow non-transparent conditions to be invoked against persons (other than good-faith acquirers), however, subject to a blocking of entries made under a non-transparent condition, and complemented possibly by a time limitation, e.g. providing that the non-transparent conditions actually cease to exist (at the latest) a specific number of days after the credit was made.

Since the principles of this Advice give predominance to book entries on a securities account, preference is given to a solution that ensures that conditions are either made transparent from the account or limited to the intermediary/system in question and/or in time.

In the event of the fulfilment of the condition, the conditional credit transforms into a "regular" credit being effective. If the condition is not met, the credit never becomes effective and the account provider would have to rectify the account (which would not constitute a reversal in the sense described below, *cf.* section 6.5).

6.3 No influence on the issuer's register

Effectiveness in the sense of the present Recommendation does cover the issue of whether an acquisition is effective *vis-à-vis* the issuer, i.e. it does not affect the question of whom an issuer must recognise as holder of its securities, in particular for purposes of voting at the general shareholders meeting and the exercise of other corporate rights. This consideration is particularly important with respect to shares in so far as a change in the holding needs to be reflected in a record kept by or on behalf of the issuer, for example in the case of German *Namensaktien* or French *titres nominatifs*. This caveat can lead to situations where the register kept by the issuer does not entirely correspond to the holdings reflected in the accounts structure maintained by account providers, for example where the relevant changes are brought to the issuer's register with a certain delay. In the meantime, the acquisition is effective whereas corporate rights cannot be exercised by the (new) holder.

This scenario has to be distinguished from the effectiveness of acquisitions of securities being dependent on the agreement by the issuer (example Germany: *vinkulierte Namensaktien*).

6.4 Reversal of acquisitions and dispositions effected by book entry

The first consideration in this context is whether there should be at all the possibility to make ineffective and/or reverse acquisitions and dispositions effected by book entry. It would be perfectly possible to establish a system whereby acquisitions and dispositions that are effected following certain rules (e.g. rules such as under Recommendation 5) are effective and irreversible without the possibility to challenge this state without having recourse to a court or other formal procedure resulting in a re-transfer. However, certain exceptions to this rule can be found in practice:

- a (previous general or subsequent specific) consent of the suffering party, or,
- the existence of specific reasons which trigger reversal of an acquisition or disposition *without* the consent of the suffering party or the necessity of prior authorisation by a judge.

6.4.1 Consent of the suffering party

The general terms of securities account agreements often comprise a set of situations in which the account provider is entitled to reverse acquisitions or dispositions without prior specific agreement of the account holder in particular if the purchase price is not paid.

There is no need for EU legislation to harmonise this practice (if not, maybe, for reasons of consumer protection, which is not the subject of the present *Advice*) as it is covered by the principle of contractual freedom. Rights of third parties are not affected.

6.4.2 Reasons allowing for reversal

EU legislation should provide for a harmonised set of reasons allowing for reversal. However, given the fact that a reversal of an acquisition or disposition can be a disruptive factor in the settlement process, the number of reasons triggering reversal should be restricted to an absolute minimum.

6.4.2.1 Erroneous crediting

Example 9: Account holder M gives instruction to buy 300 BCA shares on the market. His account provider takes the necessary steps, however mistakenly buying 3000 on the market. 3000 are subsequently credited to M's securities account while at the same time his cash account is charged correspondingly. A little later, before M realises the situation, the account provider debits 2700 to M's securities account and pays the corresponding cash back on his cash account.

EU legislation should require the national law to prescribe that erroneous crediting can be reversed. In the present scenario, M does not need protection nor are there any threats to the overall settlement process. It is important to note that if the book-entry securities have been debited in the meantime, there is nothing left that could be reversed. The authorisation to reverse erroneous crediting might equally be given in the account agreement, i.e. on the basis of a prior contractual arrangement (*cf.* above).

6.4.2.2 Unauthorised debiting or earmarking

Example 10: Account holder X gives instructions to dispose of 100 ABC shares. An employee of the account provider mistakenly enters 1000 ABC shares to be disposed of. This amount is debited to X's account.

Example 11: Account holder X and his creditor Y enter into a security arrangement under which the account provider of X shall make an earmarking in favour of Y of certain securities in X's securities account. An employee of the account provider wrongfully takes steps that lead to the earmarking of book-entry securities in Z's account.

Example 12: Account holder K creates a security interest in favour of L over securities credited to his account. His account provider makes an earmarking in order to block the securities on the account in favour of L. Later, because of a mistake of an employee of the account provider, the earmarking is removed. L claims that the removal is invalid and needs to be reversed by a converse act, i.e. the making of a new earmarking.

Example 13: As before. K disposes of the securities by selling them on the market, which is only possible because an employee of the account provider makes a mistake and unblocks the securities without asking L. L is of the opinion that his security interest is still valid because the securities are still "in the account" and encumbered in his favour, because it was impossible to unblocked them without his consent.

"Unauthorised" means generally "without instruction of the empowered person" which can be not only the account holder but under certain circumstances also the holder of a limited interest, in particular a security interest, in the book-entry securities (*cf.* Recommendation 10 on instructions).

European legislation should require national laws to provide for an unauthorised debiting, earmarking or removal of earmarking being liable to be reversed. At the same time, there is a

necessity to harmonise rules as far as the concrete legal consequences are concerned (*cf.* below).

6.4.2.3 Defect of underlying obligation?

Example 14: X concludes a contract with Y according to which X shall transfer securities credited to his account to the account of Y. Subsequently, X instructs his account provider accordingly. After the transfer is executed, X realises that he was victim of a deliberate fraud and successfully challenges the contract, which is consequently invalid under contract law.

In this scenario, Member States' laws provide for two different types of mechanism: (1) in some jurisdictions, the rules regarding the effectiveness of book-entries are distinct from the underlying (contractual) relationship between the parties to a transaction or between an account holder and its account provider; (2) in other jurisdictions the law requires a valid contractual obligation as a precondition for an effective acquisition or disposition.

It is questionable whether under future harmonised European legislation Member States should have the choice to link the validity of the underlying commercial arrangement to the possibility to reverse a book entry. Ultimately, a judge will have to decide upon the invalidity of an underlying contract. This procedure takes some time. If the possibility to reverse the relevant book entry were to depend on the decision, the acquisition would be "pending" in the meantime. Consequently, invalidity of the underlying contract cannot be a reason for reversal; the adjustment of such a situation is to be left to the common tools of civil and commercial law and legal procedures, e.g. retransfer upon court order on the basis of principles of unjustified enrichment or similar, and ultimately compensation of damages.

6.5 Legal consequences of reversal

Reversal means that a crediting or debiting or other book-entry disposition relating to book-entry securities in an account is undone by the account provider. It is important to note that reversal in the sense of the present Recommendation does not refer to the unwinding of a transaction between parties. Thus, the mechanism of reversal intervenes in relation to just one account, where a reversible crediting or a reversible debiting is countered by a converse action of the account provider.

6.5.1 Three different approaches

The term reversal of book-entries is generally used in a rather unclear way, allowing for at least three different main lines of interpretation:

- Under the first concept, a book entry that is liable to be reversed has no, and never had any, legal consequences, i.e. it had been ineffective from the outset. A credit figures on an account although no legal position is conferred upon the account holder by the applicable law. Legal reality and the information on the account balance do not comply with each other. As soon as a "reversal" occurs, the converse act consists of the elimination of the relevant figures from the account balance. It is therefore only a "rectification" of the account which, in the interim, was not reflecting the legal reality. Consequently, under this concept, there are, on one hand, credits which are liable to be reversed which therefore have no legal effect, and, on the other hand, there are "regular" credits which have immediate legal effect.
- The second concept is based on the understanding that a book entry which is liable to be reversed has legal effect like any other book entry until it *is actually* reversed. This means that the pure liability to be reversed does not change anything in terms of

effectiveness of the book entry. However, as soon as the reversal occurs the law attributes to it a fictitious retroactive effect, i.e. the account holder is treated as if the defective book entry had never occurred ("ex tunc").

- The third concept equally starts from the understanding that a book entry which is liable to be reversed has legal effect like any other book entry until it *is actually* reversed. As opposed to the second model, the reversal takes effect from the time at which it occurs and the status of the account during the interim phase remains uncontested ("ex nunc").

6.5.2 Relevance for integrity of the issue and protection of individual account holders

Example 15: On the account of account holder X stands a credit of 1000 ABC securities. He gives instructions to dispose of 100. An employee of the account provider mistakenly enters 1000 to be disposed of. This amount is debited to X's account and enters the clearing and settlement process. X is of the opinion that the debiting of 900 is invalid, that he never disposed of these 900 and that the securities account balance does not reflect his actual holding and should therefore be rectified. The account provider admits the wrongful debiting but is of the opinion that X has lost the securities and that a re-crediting is necessary which it can only do after having acquired 900 on the market – if not, the re-crediting would not be covered by its holdings with the upper-tier account provider, which is forbidden by law. Before the dispute is resolved the account provider falls insolvent. X is of the opinion that he never lost the 900 securities. The insolvency administrator admits that X has a claim against the account provider's insolvency estate aiming at re-crediting 900. However, the estate is insufficient. Is X left with a pure claim?

The first and second concept presented above would come to the result that 900 book-entry securities have not been disposed of but are still attributed to the account holder (the first concept because it assumes that they have never been disposed of, though they were not "visible" in the account; the second concept because the account holder is retroactively deemed never having lost them). Thus, in case of the insolvency of the account provider, the account holder would have book-entry securities still standing to the credit of his account and would not be left with a mere claim aiming at re-crediting of book-entry securities. However, at the same time, this approach would lead to a shortage of book-entry securities at the level of the account provider which would be irredeemable because of the insolvency of the account provider. In this scenario, the loss would probably be mutualised amongst all account holders of this account provider by the application of a loss sharing mechanism as regularly included in national insolvency laws (for details *cf. infra*, Recommendation 9). Thus, the application of the first or second concept would have positive and negative aspects.

Application of the third concept to this example would come to a result which exactly inverses the positive and negative elements: the book-entry securities would have been validly disposed of. Thus, in the insolvency of the account provider, the account holder X is left with a claim aiming at re-crediting of securities. On the other side, there would be no shortage at the level of the account provider and no loss needed to be mutualised in the event of its insolvency (because the loss is individualised with the account holder X).

On the basis of Example 15 it would be difficult to decide which approach is preferable against the objectives of preserving both the integrity of the issue and holdings of individual account holders. The first and second concept on one hand and the third on the other have significant advantages and disadvantages. Testing the three concepts against the parallel scenario of erroneous crediting instead of an erroneous debiting one would obtain similar results, again, with inversed advantages and disadvantages as compared to the solutions to the example above.

Therefore, the protection of the integrity of the securities issue and of individual account holders cannot give a sufficient indication as to which of the three approaches is preferable.

6.5.3 Conceptual issues

The first and the second concept presented above are peculiar in the sense that in both cases credits of book-entry securities figure in an account which actually do not confer any rights. Under the first concept rights have never been conferred, under the second, rights have originally been conferred upon the account holder, however, upon reversal, he is deemed to have never received anything.

It is probably fair to say that such an approach is not in line with the general idea of increasing legal certainty in respect of book-entry securities. Book-entry securities, as the core element of the overall logic of modern structures for securities holding and settlement, are inseparably tied to securities accounts. In allowing an account to appear as if book-entry securities were standing to its credit, which is actually not the case, the concept reveals that there is an additional element different from book-entries, which prevails over credit and debit when it comes to acquisition and disposition through account providers.

Apart from this conceptual inconsistency there are concrete practical disadvantages of the first and second concept: as long as book-entry securities stand to the credit of an account there is the possibility that they become object of other dealings, before the reversal occurs.

Example 16: Account holder V is a client of F-Bank and instructs to purchase 4000 ABC securities on the market. Mistakenly, F-Bank purchases only 400 ABC securities which are settled through its own account provider C-Bank. Again mistakenly, 4000 are credited to V's account and his cash account is charged accordingly. In the interim, V, (a) as a shareholder approves a stock split; (b) sells off half of the securities, and, (c) encumbers the other half in favour of creditor K, who is under the agreement receives the dividend. F-Bank falls insolvent. The insolvency administrator realises the earlier mistakes and accordingly attempts to reverse the crediting of 3600 securities. The account agreement allows reversal to the extent a crediting is not covered by the securities received from the upper-tier account provider.

From a legal point of view it would be difficult to appraise the "validity" of the stock split, the disposal, the creation of a security interest and the drawing of dividends by K if the legal analysis were to be that a reversible book entry did not confer any rights to the account holder from the outset, as it would be the case under the first concept.

An application of the second concept, which attempts to eliminate the acquisition of book-entry securities retroactively, faces similar difficulties.

Only the third concept provides for a legally sound assessment: the book-entry securities had been validly acquired in the beginning, all actions in the interim phase were equally effective because they related to book-entry securities which were effectively credited to the account: the approval of the stock split was valid, and the disposal of half of the securities as well as the creation of the security interest were equally effective. A reversal is only possible as far as the relevant book-entry securities are still available on that account (depending on the concrete make up of the security interest in favour of K).

6.5.4 Result

Consequently, it is more stringent to follow the third concept. Therefore, Member States' law should prescribe that reversible book-entries are effective until they are actually reversed. If the concept of conditional credits were to be retained (*cf. supra*, section 6.2.2), it would constitute a well defined exception to this rule. By means of reversal, the reversible book entry is undone, to the extent possible, by the making of a converse book entry.

6.6 Ineffectiveness of acquisitions and dispositions not effected by book entry

Member States' law should be free to set the conditions under which acquisitions and dispositions which are not effected by one of the book-entry methods are ineffective and determine the legal consequences of such ineffectiveness.

Recommendation 7 – Protection of acquirers against reversal

7.a EU legislation should include a harmonised rule protecting the crediting of an account or earmarking of book-entry securities or of an account against reversal.

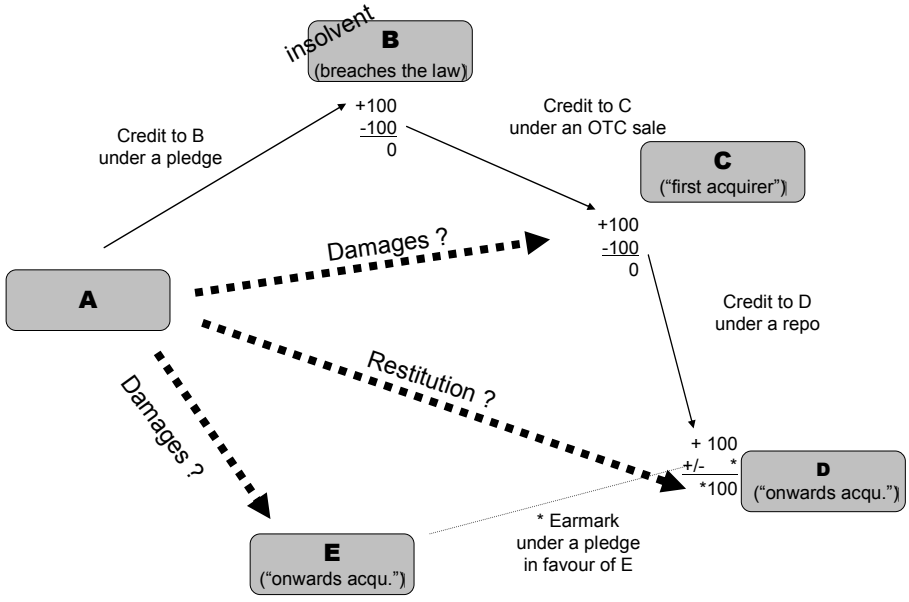
7.b An account holder should be protected against reversal of a credit unless it knew or ought to have known that the account should not have been credited.

7.c A person in whose favour an earmarking has been made should be protected against reversal of this earmarking unless it knew or ought to have known that the earmarking should not have been made.

7.1 Background

Systemic implication might occur as a result of the attempt to unwind a sequence of acquisitions because one of these acquisitions had been invalid.

Example 17: A pledges 100 securities to B entailing a credit to a sub-account of B's securities account. B (though not being entitled to them) transfers the securities to C under an OTC sales agreement, which is only possible following a technical error in the system of B's account provider. C has no idea of the previous irregularities and creates a security interest in favour of D. D is entitled under the agreement with C to re-hypothecate the securities to third persons, which he actually does in favour of E. A is now of the opinion that all transactions involving "his" securities are invalid and claims for restitution and/or damages against C, D and E, as B has fallen insolvent in the meantime.



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. Such rules are commonly termed "good-faith purchaser" rule or "*bona fide* purchaser" rule and resemble each other as regards their general reasoning, while differing considerably as regards exact legal requirements and consequences.

7.2 Need for a harmonised rule

EU legislation should harmonise these national rules in respect of book-entry securities. However, it is problematic to apply the traditional good-faith purchaser rule one-to-one to book-entry securities.

Another view has been expressed that the traditional good-faith concept had never caused difficulties in the context of holding of book-entry securities through account providers and that it was an essential tool in safeguarding the integrity of the issue. There was the fear that the application of a new concept could lead to an inflation of the number of securities.

Indeed, concrete cases are extremely rare. Furthermore, it is important to note that the traditional concept is usually understood to apply in a legal environment that is still built on the understanding that traditional rules of "transfer" of securities between parties apply. However, Recommendation 4 to Recommendation 6 above require that securities accounts are made the decisive element in holding and disposition of securities (other methods can persist, but are superseded by the account related methods). Consequently, all facts relevant for a change in the legal situation of book-entry securities will relate exclusively to securities accounts. Hence, the conceptual point of departure for a rule protecting acquirers against reversal is different from the traditional analysis.

The difficulty is based on the different nature of the substrate of the rules: on one hand, objects that are classified movables (or tangible assets or chattel), on the other, book-entry securities which are from the point of view of substance intangible, a bundle of rights and obligations, are, however, in some jurisdictions incorporated in or represented by a certificate and thereby included in the world of tangible assets. In other jurisdictions, they are intangible by nature, as there is no certificate, but assimilated to tangible assets by a legal presumption. These conceptual differences probably focus on the following points:

(a) the traditional rule is based on a the fact that possession of a tangible asset implies that the possessor is at the same time the owner and therefore entitled to transfer or encumber the asset; however, in the world of book-entry securities, it is difficult to explain the concept of possession. Even if the credit to an account is equated to possession by legal presumption, there is no satisfactory explanation on how this fact is perceivable to the receiver of the book-entry securities. First, in the context of acquisition on the market, the acquirer has no idea where the securities come from. Second, even in the case of the creation of a security interest, where security provider and security taker stay in contact, banking secrecy and the inaccessibility of operation of the system do not allow the receiver to verify from which account the book-entry securities "originate" and under what circumstances they are disposed of or encumbered; for example, the disposer could have more than one account with securities of the same description standing to the credit of both of them.

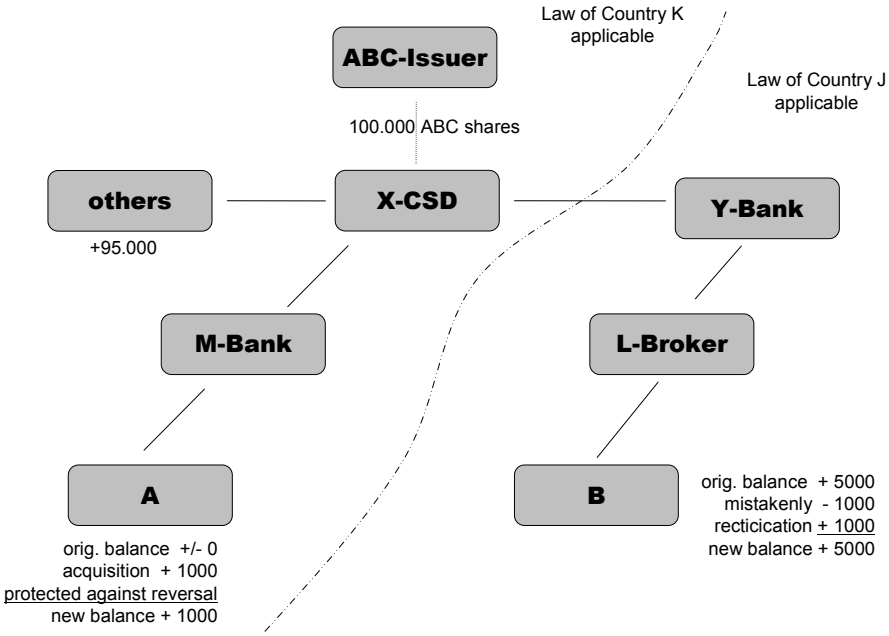
(b) The traditional rule always applies to a well-identified tangible asset; on the contrary, as regards securities held through account providers, in most jurisdictions, not the securities themselves are moved from one account to the other. Instead, a specific legal position under the national law (for example a shared property interest in a pool of securities) is acquired and disposed of. One cannot say that it is the identical asset that is transferred from one account to another.

(c) Tangible assets cannot be duplicated by application of a good-faith purchaser rule, i.e. if there is a traditional good faith acquisition, the original holder of the movable would lose the property over it; in the practice of holding and settling of book-entry securities, it can happen that the application of a rule protecting the acquirer leads to an inflation of the number of book-entry securities (not: underlying securities) as a consequence of mistake or fraud, or, that the person supposed to lose book-entry securities cannot be identified. Consequently, a protection rule must from its concept relate to the overall logic of book-entry securities and cannot conceptually remain in the context of tangibles. It is important to add that such rule must be regarded in conjunction with measure against any inflation of securities, cf. Recommendation 9

As a result it can be stated that only the account provider has access to facts that could create the impression that a book-entry was wrongful in one way or the other. In most cases the account provider itself would probably be the source of the defect as all sorts of erroneous bookings happen under its responsibility.

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, legislation should be based on a purely functional provision without allusions to traditional legal concepts and employ neutral terminology order to avoid misinterpretation. The need for a harmonised approach becomes even more apparent as soon as the interaction of such a protection rule with other principles is analysed. In particular there is a close interaction with rules regarding the effectiveness of dispositions:



Example 18: A and B are account holders of different account providers in different Member States. The law of different jurisdictions applies to their accounts. A seeks to purchase 1000 ABC shares through his account provider. The shares which are credited to A's account originate from B's account as B's account provider acted under the incorrect impression that B wanted to sell 1000 ABC shares (in reality, his instruction had been a purchase order as well). A pays the purchase price. Under the law applicable to A's account every acquisition is linked to a disposal of securities, i.e. in the case of application of the protection rule the disposer would actually lose his securities. The law applicable to B's account does not establish this link, so B does not lose his securities despite the acquisition on A's side. The present scenario leads to a situation where B does not lose his book-entry securities while A acquires 1000 book-entry securities. The aggregate amount of book-entry securities credited in the system exceeds the number of securities originally entered into the holding system (cf. Recommendation 9 for measures to eliminate such imbalances).

An even more far-reaching solution would be to abandon the concept of a separate protection rule altogether. In such a scenario, reversal would be possible on the basis of either legal provisions setting out reasons that trigger reversal or on the basis of previously agreed circumstances that would authorise the account provider to reverse. Under this concept, the requirements for acquisition and disposition would be addressed in rules reflecting Recommendation 5 and Recommendation 6, whereas Recommendation 7 would not be necessary. It is clear that such a concept would require a clear set of reasons for reversal, including the contractual agreement on reversal. The as yet unresolved difficulty of this concept lies in the question of what happens if a credit that is liable to be reversed is disposed of before the reversal actually takes place.

7.3 Scope of the protection rule

7.3.1 Protection of crediting

As regards the scope, first, such a rule should protect account holders to the securities account of which book-entry securities are credited against reversal *even* if the prerequisites for a reversal are fulfilled (*cf.* above Recommendation 6).

It is important to note that this concept differs from traditional "good-faith" concepts. Roughly speaking, the rule proposed above is built on the understanding that an account holder whose account is credited acquires book-entry securities unless he is in "bad faith", in which case the credit can be reversed and he would lose what he had acquired. To the contrary, traditional rules suppose that an account holder who is in bad faith does not acquire anything from the outset. In the latter case, the credit figuring in the account would be an "empty" one and the converse act of removing it from the account would be a rectification of the account rather than a reversal (*cf.* similar situation, above, section 6.5).

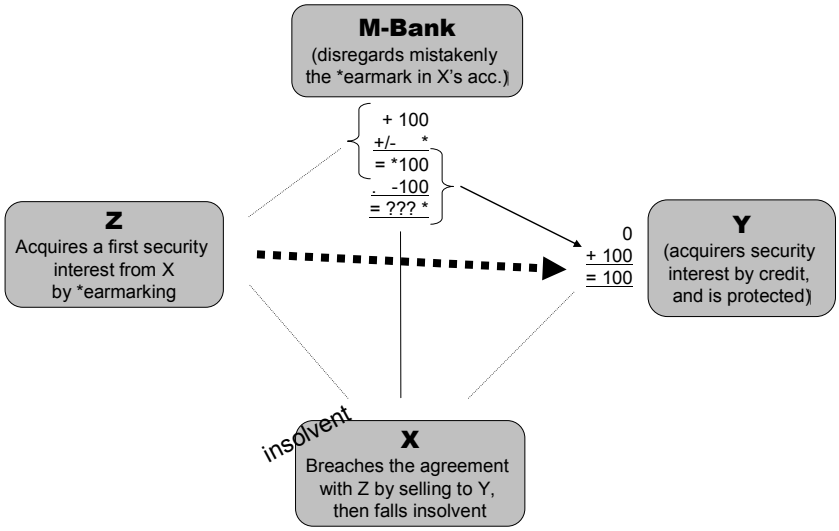
7.3.2 Protection of earmarking, exclusion of non-book-entry methods

Second, the rule should equally protect acquirers of an interest created by earmarking. The present *Advice* proposes that the conclusion of a control agreement, or an agreement with and in favour of the account provider, are excluded from the scope of the protection-of-acquirer rule and follow exclusively the rules on priority – albeit, during its preparation one voice advocated that also these methods should come into the scope.

EU legislation should assimilate the earmarking to crediting a securities account; consequently, the earmarking should be treated in the same manner in terms of the protection rules and regarding priorities. The question is whether it would be sensible to attach different legal effects to crediting and earmarking and to make the crediting superior over an earmarking in a scenario where both create a security interest over the same book-entry securities.

The market expectation is that both methods have the same value and should consequently be treated in a comparable manner. However, there is one important caveat: a designating entry can be only accessory, i.e. it always relates to a credit. The question is what happens to such a designating entry in case the credit disappears from the account because the book-entry securities have been debited.

Example 19: X grants a security interest over his book-entry securities by allowing for an earmarking to be made in favour of Z. Subsequently, and under breach of the first arrangement, he provides for a second security interest in favour of Y, this time by debit and credit of the securities without the knowledge of Y of the previously established security interest. X falls insolvent. Can Z enforce the security interest against Y? Can Z claim damages from Y? What happens technically to the earmarking?



7.3.3 Extent of protection

The protection of the acquirer consists of repelling a reversal despite the fact that a credit or an earmarking is liable to be reversed. A protection is unnecessary in case of a pre-agreed (in particular in the account agreement) or presumed consent for reversal by the account holder.

Another issue is an additional explicit protection that the acquired legal position is free from other rights (in particular security interests) in favour of third persons; and, that the acquirer is not subject to subsequent claims from a third person on grounds of the fact that the acquisition violated previously existing rights of that third person, in particular security interests. The nature of book-entry holding requires that the acquisition in both cases is free from rights of third persons:

Example 20: X has created a security interest over his securities in favour of Z. Subsequently, he sells the securities to Y who did not know that they had been encumbered and had paid the regular price of the securities. Z tries to enforce the security interest against Y.

Example 21: As above, but Z admits that he has lost the security interest but claims damages not only from X but also from Y.

7.4 Prerequisites for protection

An account holder should not be protected in case he knew or ought to have known that the book-entry securities should not have been credited or the earmarking should not have been made respectively.

This rule differs from traditional "good faith" rules in the sense that the facts to which the subjective impression of the acquirer relate stem exclusively from his own sphere. In other words, what is exclusively decisive is whether he has a quiet conscience towards the question of whether he rightly receives book-entry securities on his account or not, or whether an earmarking in his favour is correctly made or not. Under this concept it is irrelevant what happens outside the sphere of the acquirer as he cannot perceive these facts anyway, *cf.* above.

Example 22: X instructs his account provider S-Bank to purchase 100 ABC shares on the market. Mistakenly, 1000 ABC shares are credited to X's account, whereas the price of 100 is debited to X's cash account. X cannot claim protection against reversal.

Example 23: Y extends a credit to X, who in turn grants a first-rank security interest over his entire securities account with B-Bank in favour of Y. B-Bank earmarks X's account accordingly. Y had heard rumours that X' business was not going well and that he had to grant security interest over his portfolio in favour of several other persons. However, Y can only rely on the account provider acting diligently. The general apprehension that there might be irregularities cannot be taken into account. Therefore, if there were to exist prior and first-in-rank security interests over the securities booked to the same securities account in favour of third persons (e.g. established by control agreement), the account provider was acting mistakenly but Y would be protected.

As stated before, instances of reversal are probably connected to a previous error at the level of the account provider in a general manner. Against this background, the question is raised of whether knowledge on the side of the account provider could be attributed to an acquirer of book-entry securities or a designating entry. However, this cannot be the case because the attribution of knowledge of the account provider would result in a non-controllable widening of the horizon of the acquirer. The latter would never have certainty as regards the range of knowledge affecting the acquisition. This becomes even clearer against the fact that one of the principal reasons for a book entry being liable to be reversed consists of erroneous or even fraudulent book entries made by the account provider. Attributing the account provider's knowledge to the acquirer would cancel the virtue of the rule in these cases. However, there need to be obvious exceptions to this rule, in particular in case of collusion between account provider and acquirer. For the sake of completeness it should be added that there was, during the course of the preparation of this *Advice*, the opinion that knowledge should be attributed in a far broader manner.

Example 24: A, B and C are all clients of the same account provider M-Bank. A creates a security interest in favour of B by way of earmarking, subsequently a security interest in favour of C by way of crediting over all 100 KPM securities standing to the credit of his account. This is only possible because an employee of M-Bank wants to do C a favour. C himself is completely innocent. Should the circumstances be discovered, C would still be protected: the knowledge of the employee could certainly be attributed to M-Bank but the knowledge of M-Bank cannot be attributed to C.

Recommendation 8 – Priority

8.a Interests in the same book-entry securities which are acquired by earmarking rank amongst themselves in chronological order.

8.b Interests in the same book-entry securities which are acquired by control agreement or an agreement with and in favour of the account provider rank amongst themselves in chronological order.

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

8.d Parties can deviate from the above rules by agreement. Such agreement cannot affect the rights of third parties.

8.e Security interests created by mandatory operation of law should have the priority attributed by that law.

8.1 Background

Acquisition of and disposition over book-entry securities can be effected by means of various methods, as set out above in Recommendation 5. It is generally possible to effect more than one disposition over the same securities.

Example 25: Account holder X creates a security interest by earmarking over all securities booked to his account in favour of Y. Subsequently, he creates a similar interest in favour of Z, both agreeing that Y should have first access to the encumbered assets in case X does not fulfil his financial obligations.

Generally, situations where two or even more dispositions relate to the same book-entry securities should not create difficulties. However, in case of unclear or even fraudulent acting of the disposing account holder, priority conflicts can arise. Consequently, there needs to be a set of rules addressing the issue of which party would win such priority contest.

Example 26: as above, but Z had no idea of the existence of a previously created security interest.

Example 27: Account holder A creates a security interest in favour of B of by way of earmarking. Subsequently, he disposes of the securities by concluding a control agreement in favour of C. Would B lose his security interest?

8.2 Scope of the priority rule

The priority rule applies to competing rights and interest with respect to the same book-entry securities.

"Competing interests" must be understood in a very broad sense, i.e. the term envisages all types of rights and interests which can be established under the applicable law: security interests (pledge, mortgage, charge, etc.), other limited interest (usufruct and similar) and even the "full right" (property, ownership, etc.). As set out under Recommendation 5, EU legislation, on the basis of a functional approach, should not harmonise legal concepts of rights and interests created over book-entry securities, i.e. it would remain in the competence of the applicable law to determine whether security interests are created as a pledge or mortgage or any other form of right or interest. Indeed, harmonised legislation will set the requirements to render such rights and interests effective. With regard to developing a priority rule, this conceptual approach bars the European legislator from establishing priorities between different legal concepts of rights and interests, i.e. it would be inconsistent to say that

possessory pledges rank before non-possessory charges, property before mortgages, etc. Therefore, again, the *methods* used for establishing a right or an interest should be decisive; consequently, the attribution of a rank in terms of priority should happen on the basis of which method had been used.

The term "in the same book-entry securities" describes the exact object of the competing rights and interests: a priority contest can only relate to the same credits of book-entry securities to the balance of *one specific* securities account. This is to make clear that rights and interest with respect to credits appearing on *different* accounts can not constitute the object of a priority contest in the above sense.

Example 28: X creates a security interest in favour of Y over all securities standing to the credit of his securities account with M-Bank by way of concluding a control agreement. Subsequently, he makes M-Bank debiting all ABC-shares from this account and crediting to the account of Q in the context of a repurchase agreement (repo). Y claims that his security interest persists in relation to the book-entry securities now standing to the credit of Q's account.

From this principle follows that a scenario involving crediting and debiting leaves no room for the application of the priority rules. Consequently, priority rules apply to rights and interests created by (a) earmarking; (b) control agreement; and, (c) agreement with and in favour of the intermediary.

Another important delimitation of the scope of Recommendation 8 derives from both parameters: besides the account holder to whose account book-entry securities are credited there must be at least two other persons involved who claim interests in the same securities created by one of these methods. The account holder's account provider can equally be holder of an interest. Differently, the scope of Recommendation 7 addresses exclusively and necessarily the relationship between an acquirer (account holder or beneficiary of an earmarking) and the account provider as the one responsible for making book-entries and reversing them.

8.3 Elements of prioritisation

There are four elements capable of determining the order of priority of rights and interests in book-entry securities: 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 considerations that give absolute protection of certain claims.

8.3.1 Chronological order

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.

8.3.2 Preferential treatment of book-entry methods

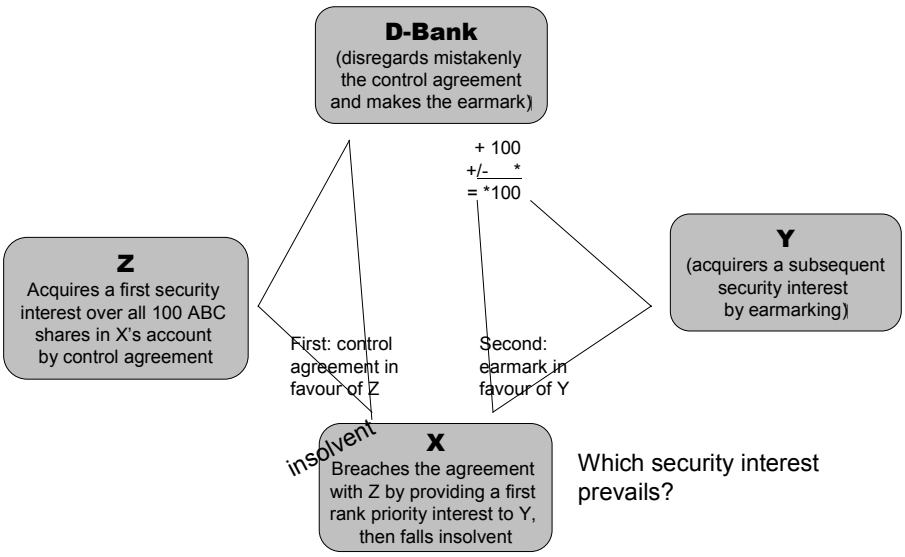
However, it is possible to attribute to interests created by means of specific methods a "better" priority although they have been established later in time as compared to other interests created with respect to the same securities but by different methods. Such alteration of the principle of chronological order by the applicable law generally has a policy decision at its basis aiming at guaranteeing higher efficiency or safety of dispositions.

The present *Advice* is generally built on the assumption that book-entries to an account should have constitutive effect as regards acquisition and disposition of securities and that the use of

book-entry securities generally increases transparency, *cf. supra* section 0). 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-book-entry methods. However, as the method of crediting is not within the scope of the priority provisions (see above), the principle stated before can only apply to the method of earmarking. In this sense, an interest created first in time but by a non-book-entry method (control agreement, agreement with and in favour of the intermediary) would rank behind an interest created by a earmarking that is created second in time.

It is unclear whether a scenario like the one below should lead to the security interest being created first in time (but "only" by control agreement) being eliminated or being pushed to the second rank in terms of access to the encumbered book-entry securities in case the enforcement event occurs. As there is no apparent reason speaking in favour of the complete elimination of the first in time security interest, it could be maintained.

Example 29: X grants a security interest to Z covering all 100 ABC shares which stand to the credit of his account with D-Bank. To this end, X and Z conclude a control agreement under participation of D-Bank. Subsequently, and under breach of the first securities arrangement, X concludes a security interest in favour of Y which is supposed to be a first-rank security interest equally over 100 ABC securities standing to the credit of X's account with D-Bank. D-Bank is requested to make an earmarking in favour of Y which it does – mistakenly, however, because it disregards the previous control agreement between X and Z. Then, X falls insolvent. Both Z and Y claim having first access to the encumbered securities, Z "because he was first in time", Y "because he used a book-entry method".



8.3.3 Change of priority rules by agreement

The principle of contractual freedom of the parties allows for the order of priority to be changed by them. However, this cannot affect the rights of third parties nor does this freedom apply to interests that arise by mandatory operation of law. One specific scenario needs special attention:

Example 30: A instructs M-Bank to purchase 100 bonds on the stock exchange. The securities are credited to A's account though the purchase price is not yet paid. Under the terms of the account agreement between A and M-Bank, a contractual security interest over the securities in favour of M-Bank is automatically created in such situation. Subsequently, A wishes to establish a pledge over the securities in favour of B. Under the applicable law, a pledge is established by way of earmarking. M-Bank assists in arranging for the pledge and makes the

earmarking without reserving or even mentioning its legal position regarding the purchase money security interest. A falls insolvent, B is of the opinion that he has a first in time security interest.

In a scenario where such a situation is not explicitly addressed by the applicable law, it is most probable that a judge would come to the result that M-Bank tacitly agreed to change the order of priorities between the various contractual security interests. However, some uncertainty as regards this result would remain. For a security taker, two aspects are of paramount importance: first, that the security interest is effective. Second, that it does not rank behind other security interests in favour of other parties, as a first ranking interest has much more value than a second or third ranking one.

Against this background, EU legislation should require the law of Member States to make clear that an account provider having an interest, in particular a security interest, in book-entry securities credited to the securities account of one of its account holders participates in the creation of a subsequent interest in the same book-entry securities in favour of a third person is deemed to consent an alteration of priorities in case it does not reserve its position. It is important to note that the analysis would come to a different result in case of a security interest of the account provider arising by mandatory operation of law; in such case, the security interest would have the rank attributed by that law.

8.3.4 Specific regime for interests arising by mandatory operation of law

Another caveat regarding the chronological order of interests stems from policy considerations: certain claims of persons or institutions are reinforced by a super-priority which is immediately attributed to them by the applicable law. There is no apparent need to interfere with the relevant rules of Member States' law. Therefore, interests arising by mandatory operation of law should have the rank attributed by that law.

Example 31: L has a small business with 5 employees. Securities of some value stand to the credit of his securities account, they are validly pledged to K (first in time, by control agreement) and M (second in time, by earmarking). L falls insolvent. The applicable law stipulates that the social security system always has a super-priority security interest over all assets of an insolvent employer to the extent social security contributions are not paid. On the basis of the above, the rank of creditors seeking to realise the value of the encumbered assets is as follows: first, the super-priority interest; second, the second in time interest because it is created by an earmarking and, third, the first in time interest because it is created by control agreement.

Example 32: F holds his securities in a securities account with G-Bank. He gives instructions to buy 200 ABC bonds on the market. The securities are credited to his account but the purchase price is not immediately paid. In the meantime, F creates a security interest in favour of H by way of earmarking. The applicable law stipulates that the purchase price is guaranteed by the automatic creation of a pledge in favour of the account provider at the moment the securities are credited to the account. H's security interest would rank behind the security interest of G-Bank, though the former is created involving a book entry.

Recommendation 9 – Integrity of the issue

9.a EU legislation should provide that an account provider has to maintain a number of book-entry securities that corresponds to the aggregate number of book-entry securities credited to the accounts of its account holders or held for its own account.

9.b In the event that an imbalance occurs, EU legislation should require application of one or more of the following measures:

- the reversal of erroneous bookings;
- the buy-in of missing securities;
- the attribution of securities held by the account provider for its own account to the account provider's account holder (clients);
- in the event of insolvency of the account provider, the loss represented by the missing securities is to be shared amongst the account holders following the law of Member States or the rules of the relevant settlement systems in accordance with the relevant law.

9.1 Background

The term "integrity of the issue" describes an important function of the model of holding and settlement through account providers: as the issuer has issued a certain number of securities, the chain of account providers must ensure the total number of securities belonging to a specific issue does not exceed the number of securities originally issued. To this end, mechanism should be in place designed to avoid imbalances at the level of account providers.

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 a problem in itself. Generally speaking, it must be the first aim of each and every account provider 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, no jurisdiction could categorically deny the theoretical possibility that an imbalance occurs. Therefore, future legislation has to take into account that there might be situations where an imbalance occurs, and that therefore it might be necessary to cure it subsequently.

The difficulty is to find mechanisms (both avoiding and curing imbalances) which would work in the different legal environments. Some rules are an adequate method under some legal systems, while they would have no beneficial effect in other legal systems.

9.2 Means to avoid imbalances

From a conceptual-legal point of view, the following techniques appear capable of decreasing the risk of imbalance.

9.2.1 Obligation to hold sufficient securities

EU legislation should set the account provider's obligation to maintain a number of book-entry securities that corresponds to the aggregate number of book-entry securities credited to the accounts of its account holders *plus* the book-entry securities held by the account provider

for its own account. This is certainly an account provider's cardinal obligation in this context. Articles 13 of the MiFID and 16 of the MiFID Implementing Directive contain a similar obligation which is, however, of regulatory nature and less concrete. Consequently, a more explicit rule is needed that would complement the relevant framework set by the MiFID (*cf. supra*, section 2.4).

This rule, however, though setting a legal obligation to hold sufficient securities, cannot avoid the occurrence of an imbalance in absolute terms. An account provider for whatever reason might not obey it, by mistake, technical error or even in the context of a fraud. There are jurisdictions where the law prescribes that credits to clients' accounts exceeding the account provider's coverage cannot lead to an effective acquisition of book-entry securities. But it is fair to say that this technique is linked to a precise legal concept of securities holding and settlement and cannot be transposed to other jurisdictions. Consequently, a breach of the obligation to hold sufficient securities might lead to liabilities of the account provider or measures imposed by the supervisory authority. But neither the obligation nor liability or regulatory consequences are capable of rectifying any imbalance in the system which had been caused by the action of the account provider.

An additional option to reinforce this principle and decrease the danger of the occurrence of an imbalance on a functional basis would consist in the introduction of a harmonised framework for regular reconciliation of securities holdings, for example on a daily basis.

9.2.2 "No credit without debit" and conditional credits

This principle is applied in a number of Member States. However, as it is closely linked to the underlying legal concept of securities holding and settlement, it would not work in other jurisdictions. The name of this principle is somewhat misleading. It appears to be a mere accounting tool (and it is an internal requirement for account providers on an accounting level) but it is also used to describe a conceptual approach to the acquisition and disposition of securities, where "ownership" (or the asset or the interest in the asset) is transferred from a properly identified alienator to the properly identified acquirer. Such transfer can happen either directly or via multiple transfers in the holding chain. A valid acquisition occurs only jointly with a corresponding loss on the other side.

Example 33: If buyer Y receives a credit for ABC securities, there has to be a corresponding debiting of ABC securities from the account of a seller (or a corresponding aggregate of debits from several sellers).

While it might be technically simpler to apply this principle in a situation where both seller and buyer have their accounts with the same account provider, in countries where this principle is applicable it does not stop there but applies to all types of securities acquisition and disposition, even if it might be (technically) difficult to identify seller and buyer. Logically, this principle could also be applied in cases where the interest is passed onward in the chain of holding, requiring the account provider to maintain at all times sufficient cover with the upper-tier account provider (in such systems, this requirement goes beyond a mere accounting requirement) and giving substantive effect to any breach of that requirement, i.e. where the account provider violates this requirement, the next-in-line person does not receive any interest.

In jurisdictions where this principle is applicable, the protection of the acquirer under a "good faith rule" applies in a manner that links the good faith acquisition of a purchaser to the loss of interest of some other party; i.e. that the acquisition of one investor has to be to the detriment of someone else (*cf. supra*, Recommendation 7).

Under the “no credit without debit” principle, a direct transfer of “ownership” (i.e. seller transfers ownership to the buyer) might be seen as the most stringent form to protect the integrity of the issue. Conceptually, there are never more securities validly credited than issued (unless the fungible pool of securities at the level of the central securities depository is reduced).

One characteristic of such system is the technique of conditional credits (*cf.* section 6.2.2). This practice is mindful to the fact that in commercial practice bookings are effected before all requirements for the acquisition of the asset (or interest therein) have been fulfilled, in particular that the interest of the seller is validly extinguished or that the account provider has received sufficient coverage. By making a booking conditional, a legal system avoids that credits which are not immediately covered by debits lead to a situation where more securities are validly credited than issued.

However, to elevate this principle to a binding common rule would touch upon the Member States' fundamental legal concepts, including the determination of the nature of the investor's interest which should be avoided under the functional approach taken by the present *Advice*.

9.3 Means to rectify unavoidable imbalances

Imbalances can occur despite the observance of means to avoid them, e.g. where an acquirer is protected against reversal, or caused by a mistake on the side of the account provider, or even caused by fraud. Cross-border scenarios are probably particularly predisposed for a failure of mechanisms which aim at avoiding imbalances because it may happen that rules that apply (effectively) on the acquirer's side differ from the rules applicable on the alienator's side (which equally work well) – however, in combination both mechanism are ineffective. Consequently, there needs to be a set of means to rectify imbalances once they have occurred.

9.3.1 Reversal of erroneous book-entries

The mechanism of reversal and its requirements are described in the context of Recommendation 6 (*cf.* section 6.4, *supra*). However, reversal is not only a means for rectifying things between account provider and account holder. Beyond this effect, there is the benefit regarding the integrity of the system, i.e. reversal is probably the easiest and most effective means to avoid imbalances, to the extent the relevant requirements are met.

9.3.2 Buy-in

In case of the occurrence of an imbalance, the account provider could take the steps necessary to acquire additional securities on the market. Subsequently, these securities are applied to make up for the deficit and cancel out the imbalance. Interestingly, the way this happens is that once the account provider has bought the securities, at the moment they are delivered they cease to exist.

The requirement to buy in securities should not be subject to contractual agreement among parties; however, such requirement might be limited by the laws of a Member States if the account provider is not at fault. In particular, the requirement to buy in does not pre-judge the question of who has to bear the cost. There should be the possibility to limit the account provider’s liability in the account agreement, notably in cases where an account provider was not responsible for the deficit, in particular in the case of the occurrence of an event beyond the control of the account provider (*cf.* Example 34).

9.3.3 Use of account provider's securities

As an alternative method to rectify the imbalance, the account provider can use its own securities and apply them to its client holdings. This might either be in the fulfilment of contract (if an effective credit had been made so far) or to rectify the imbalance in case an effective crediting has occurred.

Again, the requirement would not pre-empt the question of who has to bear the cost. An additional aspect to decide upon would be whether or not an account holder is obliged to use own securities exclusively where it is at the origin of the imbalance; similar considerations as above apply.

9.3.4 Loss sharing

If all of the above fails there need to be a mandatory mechanism that eliminates the imbalance between the aggregate number of securities credited to accounts and the number of securities issued. As there is no possibility left to *increase* the number of securities held by the account provider, the only possible solution is to *diminish* the number of securities credited to the accounts of the account provider's clients. The present *Advice* has already touched upon the issue of individualisation and mutualisation of losses in the context of effectiveness and reversal of credits (*cf.* section 6.5). There is agreement that mutualisation of the loss is the right solution in a scenario where there is an imbalance and neither reversal nor buy-in nor a use of the account provider's own securities is capable of eliminating it.

Mutualisation of the loss appears to be the right solution for two reasons: first, 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 (though, for reasons of completeness, it should be noted that the contrary view has been expressed during the preparation of this *Advice*). Second, individualisation of losses bears the risk of producing further failures by other market participants. The account holder affected by the loss could be an account provider itself, even of systemic importance. In stress situations for the financial system the failure of market participants need to be avoided at all cost, therefore losses in the system should be cushioned by mutualisation.

Consequently, Member States' laws already contain different models of loss sharing mechanisms. However, there is the question of whether these mechanisms need to be harmonised in detail as regards the following issues:

- the first issue is whether a loss sharing mechanism can intervene alternatively or cumulatively to the other measures listed above. In order to answer this question, it has to be taken into consideration that a loss sharing mechanism is capable of shifting the damage from the account provider to the account holders. This appears to be an undesirable result as this would open the door for mutualising losses where in many cases the account provider will be at the origin. Consequently, the present *Advice* strongly advocates to require in the first place reversal, buy-in and attribution of the account providers own securities to the clients' accounts. Only subsequently, loss sharing can intervene as ultimate means to eliminate an imbalance.
- the second issue is whether the opening of a formal insolvency proceeding should be a prerequisite for the application of a loss sharing mechanism. Two factors are to be considered in this context. On one hand, market participants, in times of stress, need

to be certain about their holding preferably at all times. There could be a time gap between the failure of other measures like buy-in and the opening of a formal insolvency proceeding. This time gap could result in additional uncertainty in the market. On the other hand, applying loss sharing outside an insolvency proceeding could encourage mutualisation of losses as an easy solution. Loss sharing *within* an insolvency procedure is a relatively common figure; outside an insolvency proceeding mutualisation of losses is rather uncommon.

– the third issue is who should be participating in the loss sharing: all account holders of the account provider or only those that hold securities of the kind the loss actually relates to. Both solutions have advantages. On one side, the mutualisation amongst all account holders of an account provider broadens the basis of market participants that have to shoulder the loss; consequently, the probability of the loss to cause another failing market participants or even a chain reaction of insolvencies is again diminished. On the other side, mutualisation amongst holder of the relevant kind of securities allows for a sharing in kind, whereas mutualisation across the whole range of different kinds of securities is only possible on the basis of a money based compensation mechanism.

The present *Advice* proposes to require a loss sharing in case of the opening of an insolvency proceeding over the estate of an account provider. Indeed, the most important need consists of the mutualisation of losses. Therefore, the exact parameters of the loss sharing can be left to the applicable law or the rules of a securities settlement system as far as permitted by the applicable law.

There might be the need to apply a loss sharing mechanism outside the insolvency of the intermediary by way of exception, notably in the case of the occurrence of an event beyond the control of the account provider and for systemic stability reasons. It appears unjustified to force the account provider to replace missing securities through buy-in or attribution of own securities in cases like the following:

Example 34: Account holders Q-1 to Q-n of Account Provider P hold securities in XZ-Mining Company which is located in X-Country. Account Provider P holds one third of these bearer securities through a custodian in neighbouring Country Y which has a link to the CSD in Country X, and two third through a different custodian. One day, the Government of Y-Country seizes under a pretext all securities deposited with the Custodian in Country Y.

9.4 Segregation

Segregation means "recognition of clients' holdings at the level of the upper-tier account provider". Segregation is a pure means to distinguish clients' assets from the account provider's assets in order to assist allocation of the segregated book-entry securities to account holders, in particular in the event of insolvency of the account provider, *cf.* Article 13(7) of the MiFID[34] and to make clear that they are not part of the insolvency estate of the account provider[35]. Segregation has only a further substantive meaning only if specifically

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[34] Art. 13 (7) MiFID: "An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent."

[35] Art. 21 (3) of Unidroit draft Convention: "Subject to Article 14, securities allocated under paragraph 1 shall not form part of the property of the account provider available for distribution among or realisation for the benefit of creditors of the account provider."

attributed to it in particular by way of a rebuttable presumption that segregated book-entry securities cover holdings in clients' accounts and can therefore not be attached by an account provider's creditors, *cf. infra*, section 11.2. Consequently, it is not an appropriate means to address the issue of rectifying imbalances.

Recommendation 10 – Instructions

10.a EU legislation should ensure that an account provider is neither bound nor entitled to give effect to any instructions with respect to book-entry securities given by any person other than his account holder or a person legally entitled to do so.

10.b An account provider shall execute instructions given by the entitled person promptly and with due care.

10.c The above rules can be modified by the account agreement.

The person who is authorised to give instructions should be the account holder. If a right or interest is created in favour of a third party it should be considered whether the account holder or the interested beneficiary of the interest or both should be entitled to give instructions to the account provider with regard to the disposition of the right or interest. However, the different nature of the rights at hand may prejudice the adoption of a common solution.

The account holder or entitled person should be able to give instructions only to its account provider, i.e. the account provider that maintains the securities account for him. Therefore, in a multi-tier system, the account holder should have no right to instruct any other account provider.

The reverse side of the rights of the account holder is the obligation of the account provider to follow the instructions to the extent that the account provider has agreed to execute the relevant type of instructions and that there is sufficient cover in the relevant securities account.

Recommendation 11 – Attachments

11.a EU legislation should provide that creditors of an account holder may attach book-entry securities only at the level of the account provider of that account holder.

11.b Creditors of an account provider may not 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 (segregated client accounts). Where the law provides for a presumption that accounts opened by an account provider with a second account provider contain clients' assets, the presumption applies.

There are two scenarios which need special attention when it comes to attaching book-entry securities, as opposed to attaching other interest or chattel: on one hand the prohibition of upper-tier attachment, and, on the other hand, the attachment of segregated client accounts. Whilst both mechanisms relate to "attachments" they deal in fact with two different issues.

Terminology: Attachments are judicial or administrative acts or processes to freeze, restrict or impound book-entry securities of an account holder in order to enforce or satisfy a judgments or similar act, also in case they are criminal law based.

11.1 Prohibition of upper-tier attachments

The phrase "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.

Example 35: Account holder A holds ABC-Securities with account provider X. Account provider X pools all its clients' securities into one single account which is held with the CSD. The creditor of account holder A tries – upon failure by A to pay the credit back – to attach A's ABC-Securities. As the ABC-Securities are issued as physical certificates, which are in custody with the CSD, the creditor obtains an attachment order against the CSD that the securities had to be delivered to him.

Already the Second Giovannini Report advocated a prohibition of upper-tier attachments. The prohibition is essentially designed to allow the unhampered use of "omnibus" accounts and to ensure the efficient operation of the indirect holding system (*cf. infra,* section 13.2.1).

This general principle may have to be nuanced when it comes to drafting a rule:

- In holding arrangements where legal relationships exist only between the account holder and its 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, like for instance under the German concept of securities holding, 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:
  - 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 (*cf. supra*, section 2.5);
  - 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.
  - where two levels of account providers are constantly connected via a conciliation and exchange of account data, the issues are probably identical to those described immediately above.

11.2 Prohibition of attachments of segregated client accounts by creditors of the account provider

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.

Example 36: Account holders X, Y and Z hold securities with account provider A who in turn opens in its name two securities accounts with account provider B, one being identified as a "proprietary account" the other as a "client account". A creditor of account provider A wishes to attach account provider A's assets and seeks and obtains an attachment order which provides for the attachment of "all accounts opened in the name of A". Faced with the order account provider B freezes both the proprietary and the client accounts of account provider A in its books, both accounts being opened in the name of account provider A albeit with different headings. X, Y and Z complain that they cannot dispose of their securities until the attachment order is released (which takes some time following local procedural rules).

Articles 13(7) and 13(8) of the MiFID and Article 16(1)(d) of the MiFID Implementing Directive 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 direct

account provider and to prevent the use by the account provider of client securities for own account.

A problem arises because, although the MiFID provides for a segregation requirement, it does not draw any legal consequences from such requirement (*cf. supra,* section 9.4). Therefore, the idea is to provide that creditors of an account provider may not attach accounts which are identified as "client accounts" with a higher-tier account provider.

One may wish to consider the extension of the prohibition to any right of pledge, set-off or retention of the higher-tier account provider itself with respect to the client account, except, may be, where claims of the higher-tier account provider arise in the course of the operation of the client account. 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.

Part II
Differences in national law affecting corporate action processing (Barrier 3)

When outlining its strategy for future action regarding post-trading arrangements in 2004, the EU Commission drew on the findings of the two Giovannini Reports. In addition to the three areas clearly denominated as "legal barriers" by the two Reports (Barriers 13, 14 and 15, *cf. supra*), the Commission added that there are legal aspects to barriers of predominantly technical and operational nature. In particular, the existing differences in national legal provisions affecting corporate action processing needed to be addressed in addition to measures aiming at removing the operational obstacles identified under the label of Barrier 3. The operational aspect of differences in corporate actions processing is dealt with by the CESAME Group in co-operation with industry groups.[36]

National differences in the legal rules governing corporate actions are a potential barrier to efficient cross-border clearing and settlement because corporate actions require passing down and up of information, instructions and distributions the manner of which must normally conform to local customs and procedures some of which are provided for in the law. Additionally, differing practices and diverging rules lead to inconsistent treatment of investors.[37]

The Commission highlighted the principle of subsidiarity by drawing the Group's attention to the fact that specific regard had to be given to the question whether any additional measures are needed at the EU level,[38] rather than at the national level. The present *Advice* comes to the conclusion that harmonised legislation in the EU Member States was needed, albeit with a limited scope. All other issues are either outside the mandate of the Legal Certainty Group or can be addressed on a national level or by industry action, *cf.* description of the scope in Recommendation 12. However, in order to enhance cross-border processing of corporate actions, two aspects need to be addressed in a common effort, *cf.* Recommendations 13 and 14.

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[36] Cf. work of the CESAME Group on Barrier 3, http://ec.europa.eu/internal_market/financial-markets/clearing/cesame_en.htm.

[37] First Giovannini Report, p. 47.

[38] Note to the Chairman of the Legal Certainty Group, 19.09.2006, p. 2, http://ec.europa.eu/internal_market/financial-markets/docs/certainty/reply_note_en.pdf.

Recommendation 12 –
Scope of legislation on processing of corporate actions

EU legislation is needed in order to dismantle legal obstacles to corporate actions processing arising from cross-border holding of securities through chains of account providers.

Terminology: Corporate actions: all kinds of action triggered by the issuer or by the terms of a security and affecting the security (equity or debt). Processing of corporate actions: functions which are necessary in the chain of account providers, in order to ensure that the investor participates in corporate actions, these comprise: (a) the timely and full notification to the investor of a corporate action affecting his rights or requiring his action and providing of all other necessary information; (b) making available to the investor all benefits from or enabling the investor to the full enjoyment of the rights vested in the securities he is entitled to; (c) facilitating of the exercise of the rights vested in securities by the account provider to the benefit of the investor. Investor: following Recital 3 of the Shareholders' Rights Directive, the investors are considered to be those who bear the economic risk of the investment. It is sufficient to rely on a functional description of an investor, rather than develop a legal definition. Similarly, the investor could be referred to as the account holder who does not hold the securities as part of his functions as an account provider.

12.1 Background

The particular complexity of the legal environment surrounding the processing of corporate actions through modern securities settlement and holding systems stems from the fact that the relation between the issuer and the investor is modified in operational, and sometimes even legal, terms.

The original function of a security is to render the interest between issuer and investor negotiable. To this end, the security was embodied in a paper certificate, in order to evidence and identify at a given point in time the person entitled to the corporate actions. At the same time, the issuer is bound to pay dividends or similar payments to that person, upon which it has the certainty that it is released from its obligation. This evidence and identification function has always been the indispensable and key characteristics of a security. It has been developed with respect to certificated securities and was perpetuated so as to apply to dematerialised securities as well.

Modern securities holding structures might change that evidentiary function of securities, potentially affecting the reciprocal positions of the investor and the issuer. However, the evidentiary function is still needed after the *de facto* disappearance of certificated securities. Thus, the mechanisms of modern settlement and holding systems have to guarantee this function.

In systems where securities are held through account providers, the issuer-investor relationship is supplemented by several legal relationships involving one or more account providers. In some jurisdictions, legal relationships involving account providers have even substituted the direct legal relationship between issuer and investor. This leads to a multiplication of legal relationships. Consequently, the various rights and obligations related to administration of the evidentiary function of the securities are more complex from the operational and sometimes even legal point of view. The phenomenon becomes particularly apparent from the fact that investors in all Member States tend to deal exclusively with their account providers, even in respect of rights and obligations that they have directly *vis-à-vis* the issuer.

12.2 Issues outside the scope

Difficulties in corporate action processing are wide spread. They relate for example to voting at a general shareholders' meeting, to incompatible notification processes, to the different identification of the moment of transfer of ownership, to an incompatible record date, ex date or payment date, to different standards in electronic communication between investor, account providers and issuer, or to differing rules on the liability for wrongful translation of documents supporting corporate actions, etc. Yet, the present *Advice* does not address but a limited number of these inconsistencies. Its scope is insofar restricted by the mandate of the Legal Certainty Group, by the context of the overall exercise, and by the principle of subsidiarity. Consequently, it addresses exclusively issues that fulfil cumulatively the following criteria:

- they are legal issues,
- they stem from the fact that securities are held through account providers, and,
- they arise because of the involvement of a cross-border element.

12.2.1 Legal *vs.* operational issues

Barrier 3 covers a broad range of operational topics. The differing practices, information requirements, deadlines for corporate actions and other diverging legal and non-legal provisions in Member States lead for example to inconsistent treatment of compensation and cash accruals, inhibit the centralisation of securities settlement and custody and thus require specialised local knowledge and the fulfilment of local requirements like for example the local lodgement of physical documents.

The Second Giovannini Report advocated that the private sector should take the lead in removing this barrier and should present a set of agreed proposals on harmonised rules to national governments.[39] Therefore, Barrier 3 was mostly dealt with by the CESAME Group under the label of the harmonisation of operational arrangements.

Under the umbrella of the CESAME Group, the relevant industry associations work in joint working groups in order to prepare a set of "Market Standards" for the most common corporate action events and the relevant procedures, covering[40]

- so called "mandatory distributions", addressing in particular distribution of interest or dividend payments;
- reorganisations and transaction management;
- attendance of general meetings, relating to the notice to convene the general meeting, to shareholder qualification and record date, and to notification of attendance.

However, there is common sense that some differences relating to corporate actions processing are embodied in law, in particular in Member States' corporate law. The removal of these differences would require national legislation to be changed. But still, more analysis is needed: applying the criteria set out above, it is still to determine whether such issues create legal uncertainty and would therefore form part of the scope of the present exercise.

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[39] See Second Giovanni Report, p. 10.

[40] Full documentation is available at http://ec.europa.eu/internal_market/financial-markets/clearing/cesame_en.htm.

12.2.2 Legal issues that do not originate from holding through account providers

The *Advice* aims only at legal issues in connection with modern holding structures for securities, i.e. the holding through book entries. Holding of securities of other types than book-entry securities is therefore outside the scope. This principle must be transposed to the matter of corporate actions processing in the following manner: issues which do not stem from the phenomenon of holding through modern clearing and settlement structures are not covered by this *Advice*, even if they often become manifest in the context of holding through account providers.

For instance, the current rules, regulations and market practices in relation to exercising voting rights in general meetings differ widely from country to country, amongst other things as regards the so called record date. The Shareholders' Rights Directive does not provide for a comprehensive solution of this problem. Several stakeholders would appreciate a greater harmonisation across Europe and point to the fact that the record date is a mechanism figuring mostly in Member States' corporate law and that therefore this was a legal issue.

In cases like this the differences between the various laws of Member States' exist independently from the holding of securities through account providers. Therefore, the variety might be a legal issue; however, there is no legal uncertainty about it. Consequently, it remains outside the scope of the present exercise.

12.2.3 Legal issues that arise independently from a cross-border element

In relation to corporate actions processing, difficulties can arise already within a purely domestic context. The reason lies again in the complexity of multiplied legal relationships between issuer, account providers and investor, as described above. Given that this complexity exists in most Member States of the EU it is obvious that similar problems can arise in more than one jurisdiction.

Example 37: An account provider has specific unpublished knowledge regarding the issuer which is capable of affecting the value of the investment. However, it processes a specific corporate action, e.g. an increase of capital stock without forwarding this piece of information to its account holders (clients). Under the applicable law it is unclear whether the account provider is bound to forward that information to its account holders. Afterwards, the account provider's clients claim damages. Investors in other EU countries have similar problems.

Legal uncertainty which stems from a legal inconsistency of the domestic legal framework is not covered by the mandate of the present exercise, even if there were similar legal problems in more than one EU jurisdiction.

12.3 Global and functional scope

The *de facto* operational "separation" of the investor from the issuer as described above is accompanied by legal incompatibilities as soon as a holding chain reaches cross border. 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. This difficulty applies in theory to all cross-border holdings within the EU and beyond. Because of this generality, incompatibilities can only be removed under a global approach which does not aim at dismantling specific points of conflict between different jurisdictions and holding models. A piecemeal approach covering difficulties in cross-border corporate actions processing would be technically complicated and would risk leaving out important issues.

Therefore, the present *Advice* advocates to enhance cross-border corporate action processing 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, *cf.* Recommendation 13, *infra.*
- 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, *cf.* Recommendation 14, *infra.*

12.4 Relation to the Shareholders' Rights Directive

The Shareholders' Rights Directive in its Article 13 addresses the issue of enabling investors to vote at general meetings in cases where the issuer law does not recognise their position. This issue is closely linked to the approach taken in Recommendation 13; indeed, the Directive already resolves an essential part of the overall issue. However, other important issues have not been covered so far. In particular, the Directive does not address other corporate actions than voting, nor securities other than shares in listed companies. Furthermore, its rules cover only scenarios based on the fact that an account holder is regarded as the shareholder but does not cover any other reason, *cf.* sections 13.3 and 13.4, *infra.*

Some additional elements relevant in the present context have been discussed during the evolution of the Directive and the assessment of the need of a Recommendation on Shareholders' Rights, notably[41]: (a) the definition of the "ultimate investor"; (b) casting of split votes by management companies of collective investment schemes; (c) allowing both segregated and omnibus accounts for account providers in all Member States; (d) duty of account providers to cast votes for investors or to transfer voting instructions to another account provider. Issues (a) to (c) are neighbouring with Recommendation 13, whereas (d) already points to the subject matter of Recommendation 14.

Both the work on Shareholders' Rights and Part II of the present *Advice* are intertwined. Recommendations 13 and 14 are shaped so as to complement the scope of the Shareholders' Rights Directive. At the same time, they follow a functional approach.

12.5 Unidroit draft Convention

The Unidroit draft Convention does not have corporate actions processing as its main focus. However, important provisions addressing this subject are included in the text.

- Article 7(1)(a) addresses the issue of who is the entitled person. The provision is based on the understanding that the person that holds securities for its own account is the entitled person; however, the matter is ultimately left to the applicable law.
- Article 7(2)(b) determines that corporate rights can be exercised either against the account provider or the issuer of securities, or both, according to the relevant legal rules.

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41 *Cf.* Second *and* Third Consultation on fostering and appropriate regime for shareholders' rights, by the Services of the Internal Market General Directorate, 13.05.2005 and 30.04.2007, http://ec.europa.eu/internal_market/company/shareholders/indexa_en.htm.

- Article 8(1) prescribes that an account provider must take appropriate measures to enable its account holders to receive and exercise corporate rights; however, this obligation does not require the account provider to take any action that is not within its power or to establish a securities account with another account provider.
- Article 26(1) prescribes that adhering States shall permit the holding through account providers of exchange traded securities. They shall equally permit the effective exercise of the rights attached to such securities in accordance with Article 7(1) of the draft Convention.
- Article 26(2) requires Contracting States to recognise the holding of exchange traded securities by an account provider acting in its own name but on behalf of its clients and shall permit such account provider to exercise split voting or split the exercise of other corporate actions.
- Article 26(3) confirms that the Convention does not determine whom an issuer is required to recognise as the holder of securities.
- Article 27(1) makes sure that a right to set off that might exist against an issuer (in particular of bonds) is not precluded just because of the fact that the securities are held through account providers.

Recommendation 13 -
Recognition of different holding patterns for the purpose of processing of corporate actions

13.a EU legislation should require the law of Member States to recognise and be compatible with holding patterns used in other jurisdictions in order to improve corporate action processing in a cross-border environment.

13.b In particular, Member States' law should recognise

- holding through one or more account providers;
- holding through omnibus accounts; and
- holding of securities by an account provider acting in its own name for the account of another person or other persons,

and investors should not be discriminated by the law of the issuer, as regards in particular the exercise of the rights enshrined in their securities, due to the fact that they use one of the above holding models under a law different from the law of the issuer.

13.c This Recommendation does not aim at changing Member States' law determining whom an issuer is bound to recognise as holder of its securities or specifying which particular holding pattern or patterns account providers should offer to their domestic account holders.

13.1 Background

Across the European Union, the law recognises different models of holding, as discussed in Part I of this *Advice, cf.* Recommendation 2 and Recommendation 4, *supra*. In some Member States, the legal analysis is very closely associated with the practical holding structure that is in place in that Member State. This means that in a domestic context, the legal framework fits perfectly to the practical make up of securities holding and settlement, tying in perfectly with other areas of law, taxation procedures and oversight and governance policies. However, where the law is exclusively tailored to reflect domestic holding and settlement structures and does not allow for sufficient flexibility, difficulties might occur as soon as the legal framework needs to connect to a holding system which is made up differently.

Often, such incompatibilities hamper the exercise of the rights attached to the securities by the investor. The most evident example is the restriction on voting at the general meeting, now dealt with in the Shareholders' Rights Directive (*cf. infra*). However, the Directive does not solve all problems in this area. There is an important remainder relating to both voting and various other rights flowing from securities. A comprehensive list of rights conferred upon a holder of securities cannot be drawn up because the available rights heavily depend on the issuer law and terms of issue, however, the most common ones are

- attend shareholders' or bondholders' meetings, voting thereat, asking questions, table draft resolutions, making motions (basically addressed in the Shareholders' Rights Directive for shares only);
- challenge voting results of a shareholders' or bondholders' meeting;
- draw dividends, interests or other payments;
- exercise a subscription or exchange right;
- accept a takeover-bid or similar offer;
- participate in reorganisation and restructuration.

13.2 Restrictions contained in the issuer law as obstacle to the exercise of rights

13.2.1 Restrictions stemming from the identification of an account provider as holder of securities

Example 38: Issuer P and Account Provider M are situated in Member State X. The holding and settlement structure in that Member State provides for just one level of account providers between the CSD and the investor, not more and not less. Therefore, all mechanisms included in the relevant laws are built on the understanding that the account providers' clients are proprietors of the securities held in the CSD. One of Account Provider M's clients is Q-Bank of Member State Y, holding securities on behalf of its own clients. The law of Member State X regards Q-Bank as proprietor and shareholder.

A common difficulty is that the issuer law identifies as the person entitled to exercise the rights attached to the securities an account provider instead of the investor. In such cases the chain of account providers is unable to evidence effectively the person who should be entitled to the rights as the law provides for a clear answer to that question (though the result from the economic point of view might be incorrect). This fact creates significant difficulties not only with respect to the present context but equally with regard to taxation of the investment[42] or threshold reporting. There is a variety of reasons which might lead to a distorted cross-border analysis regarding this question. Three main issues, which are in practice often intertwined, can be identified:

- The law recognises none or only one account provider below the CSD level, others recognise multi-tier holding systems in their jurisdictions, *cf.* Example 38, *supra*.
- The law does not recognise holding by means of "omnibus accounts". In multi-tier holding structures, account providers hold their account holders' securities in omnibus accounts. This means that the lower-tier account provider holds its clients' securities on an aggregate basis in one single account with the upper-tier account provider, without identifying individual clients' holdings. On the contrary, in other Member States, individual investors are identified through the entire chain.

  Example 39: as above. Q-Bank holds its clients' securities in one single account with Account Provider M without identifying any individual holdings or even clients' names. X-law does not prohibit expressly holding through more than one account provider but requires identification of investors up to the CSD level. As a consequence, only B-Bank itself is named, by Account Provider M, as holder of the securities and therefore regarded as proprietor by X-law.

- The law does not recognise that account providers hold in their own name but for the account of their clients. Many legal systems are built on the assumption that investor and legal owner are always identical. In other systems, legal owner and investor are not necessarily identical, i.e., an account provider can be legal owner of securities which it actually holds for clients.

  Example 40: the law of Member State A is generally built on the principle that the ultimate account holder in a holding chain is proprietor of the securities, with respect to securities which are held in the local CSD. However, as regards securities deposited with foreign CSDs, the upmost account provider in Member State A (the one which has the "link" to the relevant foreign CSD), has the legal position that it obtains under the law applicable to holdings in the foreign CSD, e.g. "ownership". Under the general terms and conditions used in Member State A, the upmost account provider acts as a trustee for the investors in Member State A.

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[42] *Cf.* Fact-finding study on fiscal compliance procedures related to clearing and settlement within the EU (2006) *and* Solutions to fiscal compliance barriers related to post trading within the EU (2007), The Fiscal Compliance Group (FISCO).

In many cases, account providers strive to make the exercise of the rights by their clients possible by setting up specific mechanism to enable an "oblique" exercise. For example account providers which are themselves regarded by law as the person entitled to exercise rights attached to the securities might

- exercise their own rights under instructions received from the account holders (investors);
- might give the power of attorney to their account holders (investors) for the attendance of a general meeting and voting.

Such remedies require by their nature additional operational efforts. Yet, their success depends on whether the issuer law recognises them, which is not always the case.[43]

Example 41: as above. Q-Bank has three clients holding securities of Issuer P: A, B, and C. Client A wants to attend the general annual meeting personally. Q-Bank would be happy to appoint him as proxy for his part of the securities holding. However, the X-law does not recognise him as a proxy for Q-Bank. Clients B and C would prefer Q-Bank to channel their vote to the general meeting through the chain of intermediaries. Client B wants to vote against a proposed dividend increase whereas C would vote in favour of it. However, as Q-Bank is regarded by X-law as the proprietor of the securities, it cannot split its vote according to its clients' instructions. This is because X-law presumes that one person cannot have a split opinion on one and the same issue.

Example 42: as above. After the annual general meeting of the issuer, A and B wish to challenge a part of the voting results following the terms of incorporation of the issuer. However, the terms provide that only a shareholder can do so. Q-Bank is unable to engage in a court proceeding on behalf of its clients.

13.2.2 Discrimination

Example 43: Investor A is a resident of Member State X. He is client of Account Provider B situated in Member State Y. Through this account he wishes to hold securities from an issuer situated in Member State X, together with securities of issuers in various countries. X-law (the issuer law) prescribes that citizens and entities in Member State X cannot hold securities in omnibus accounts but only in individual accounts thus making it overly complicated to hold such securities through foreign account providers. On these grounds, Account Provider B is not able to provide services to Investor A in respect of X-law securities.

Example 44: The law of Member State Y ties various legal consequences to the question of whether investors are legal owners of securities or whether they are not. However, the law provides only for one holding method capable of attributing legal ownership to the holding, which is having a securities account governed by the law of Country Y and maintained by an account provider governed by the law of Country Y

These examples shows that the investor's right to choose the holding pattern of securities and the account provider might be hampered for reasons which are not related to an attribution of the status of holder of securities to an account provider. Here, the law discriminates for different reasons, possibly reflecting considerations regarding taxation, investor identification for governance reasons, or similar. Impediments of this type equally stem from the fact that securities are held cross-border and through account providers. Consequently, they fall within the scope of the present exercise.

Contrarily to the category of restrictions described in the preceding section, there are additional elements coming into play, in particular residence or nationality. However, discrimination with respect to the holding pattern, the choice of account provider or the

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[43] The matter is equally important in the area of regulation, notably in the context of notification of the reaching of holding thresholds regarding voted shares: Article 9(4) Transparency Directive prescribes that the notification requirement "shall not apply to shares acquired for the sole purpose of clearing and settling within the usual short settlement cycle, or to custodians holding shares in their custodian capacity provided such custodians can only exercise the voting rights attached to such shares under instructions given in writing or by electronic means."

exercise of rights flowing from securities hampers the development of a pan-European post-trading market.

The effects of dismantling of discriminatory measures would be that (a) investors would be free to choose between a domestic and non-domestic account provider and (b) the account providers would be free to offer services cross-border irrespective of the investors' nationality, residence or other factor.

13.3 Remaining scope after implementation of the Shareholders' Rights Directive

The difficulties exemplified above are to a great extent addressed in Article 13 of the Shareholders' Rights Directive, which "applies where a natural or legal person who is recognised as a shareholder by the applicable law acts in the course of a business on behalf of another natural or legal person (the client)":

- according to Articles 13(5) and 10(1) to (3) such shareholder can appoint without any restrictions any number of proxy holders to attend and vote at a general meeting in his name;
- according to Article 13(4) such shareholder shall be permitted to cast votes attaching to some of the shares differently from votes attaching to other shares.

The scope of these provisions covers what is probably the most important impediment to an effective exercise of rights attached to securities, notably difficulties to exercise the voting right with respect to publicly traded shares. It is, however, restricted and does not remedy obstacles to the exercise of rights attached to the securities to the following extent:

First, in respect of publicly traded shares in companies, corporate rights other than attending the general meeting and voting are not yet addressed, in particular (a) challenge voting results of a shareholders' meeting, *cf.* Example 42, *supra*; (b) the drawing of dividends or other payments; (c) the exercise of a subscription or exchange right; (d) the acceptance of a takeover-bid or similar offer; (e) the participation in measures aiming at reorganisation or restructuration.

Second, as regards attending the general meeting and voting, the Shareholders' Rights Directive addresses exclusively restrictions stemming from the fact that an account provider is regarded as legal owner of the shares. Restrictions based on other considerations, or discrimination on grounds of nationality or residence, are not covered.

Third, non of these aspects is dealt with in respect of securities other than shares in listed companies. Notably, the exercise of rights attached to bonds is entirely left out.

13.4 Global and functional solution

The present *Advice* advocates a global and functional solution[44]:

- all securities held through account providers should be covered;
- the exercise of all types of rights attached to securities should be addressed;
- both types of restrictions should be eliminated, i.e. the exercise should not be hampered because an account provider is qualified as the holder of the securities, nor

[44] *Cf.* Unidroit draft Convention Article 26(1) and (2).

because of any discriminatory rule contained in the issuer law which is not covered by the caveat described under section 13.5.

The present *Advice* therefore advocates making Member States' law recognise the multi-tier holding structure, the use of omnibus accounts, and the holding of clients' securities by account providers under their own name but for the account of their clients. This principle should be complemented by a rule stating that investors should not be discriminated by the law of the issuer, due to the fact that they use one of the aforementioned holding models under a law different from the law of the issuer[45].

13.5 Issuer-investor relationship

However, the present Recommendation does not determine whom an issuer is bound to recognise as holder of its securities.[46] Its purpose is not to change the issuer law in the sense that the shareholder should be identified following different rules. Rather, the present *Advice* recommends a functional approach, along the lines applied in Article 13 of the Shareholders' Rights Directive.

Furthermore, this Recommendation does not aim at changing Member States' law specifying which particular holding pattern or patterns should be offered by account providers to their *domestic* investors. For example, it does not aim at requiring account providers to offer omnibus accounts or holding in the own name on behalf of the client to their domestic account holders where there is currently a different holding pattern applied in accordance with the Member State's law.

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[45] Article 17(1) of the Transparency Directive and Article 4 of the Shareholders' Rights Directive oblige issuers to treat shareholders who are in the same position equally. However, this obligation does not address the present issue as it refers to *shareholders* who are in the same position.

[46] *Cf.* Unidroit draft Convention Article 26(3).

Recommendation 14 –
Harmonised role of account providers in the processing of corporate actions

14.a EU legislation should provide for a framework regarding the passing up and down of relevant information received through the chain of account providers, which is required in order to exercise a right enshrined in the security *vis-à-vis* the issuer and which is targeted at all investors in securities of the same description.

14.b The legislation should at least foresee that the account provider is facilitating the exercise of rights by the account holder *vis-à-vis* the issuer or a third party either by the account holder acting directly or by the account provider next in the chain upon authorisation and instruction by the account holder.

14.c Exercise of rights on behalf of the account holder on the basis of an authorisation or instruction should be required for at least the collection of dividends and interests, for the exercise of subscription or exchange rights as well as for the acceptance of takeover bids, mergers, other purchase offers and conversions.

14.1 Background

Different approaches to the role of account providers in corporate action processing can be found across the European Union, ranging from complete silence of the law to detailed regulation. Many jurisdictions set out just fragmented or unclear rules in this regard. Where there is no or just an incomplete legal framework for the processing of corporate actions and the passing up and down of information, in most cases, market practices or standard account agreements would fill the gap. Against this variety it does not come as a surprise that the EU picture of the role of account providers in respect of corporate action processing and the passing up and down of relevant information is conceptually heterogeneous. Examples:

- *Under French law the account provider has to facilitate the exercise of the rights related to financial instruments, more specifically, the account provider must inform the client of any corporate actions which require the client to answer and of any events which would change the rights and which the account provider believes to be unknown to the account holder. However, the practical conditions like the precise timing, the cut-off date, etc. are determined by market practice and not by law. As an exception, the issuer itself has to inform the shareholder about the general meeting.*
- *The provisions in the Dutch Civil Code dealing with the exercise of investor rights are based on the assumption that the securities are directly held by the investor – and not via a chain of account providers. Consequently, the civil law does not define any role for account providers.*
- *In Italy it is not clear whether the lowest-tier account provider or the upper-tier account provider has to issue the electronic notification which has to be issued – according to the law – by the "account provider holding the accounts".*
- *Bulgarian law does not have any general rules addressing the functions of account providers in the context of processing of corporate actions. However, two obligations for the CSD exist. First, it is obliged to provide information about the registered securities to the account holders. Second, the CSD is obliged to pay dividends, interest, etc. to the bank accounts of the account holders as far as instructed by the issuer.*
- *Under German law there is no legal obligation for an account provider to exercise voting rights on behalf of account holders, unless the account provider offers such services to its account holders, is duly authorised by them and informs the account holders as to how it will exercise their voting rights in the relevant shareholders meeting unless the account holder instructs him differently. However, the investor can authorise another person to exercise any corporate rights, either by an express power of attorney (proxy), or by any kind of implied power of attorney. For the most frequent corporate action,*

the collection of dividends, the power of attorney is provided for in the Special Conditions for Securities Dealings which form part of the securities account agreement.

14.2 Need for harmonisation

This inconsistent picture is the starting point for considering any need for EU legislative action regarding the role of account providers in corporate action processing. However, the fragmented, even highly patchy picture is not a reason in itself for taking legislative measures. The question is rather whether a truly pan-European post-trading landscape can only be achieved by means of harmonised legislation.

On one hand, from a purely domestic and functional point of view it appears irrelevant whether there is a *legal* framework on processing corporate actions or not, as long as they are actually and properly processed. Consequently, in terms of subsidiarity, there might be the argument that EU legislative action is unnecessary, in particular as account providing is a service with freely negotiable terms, including the possibility of providing value added services.

On the other hand, difficulties occurring in the framework of the exercise of rights attached to the securities hamper cross-border securities holding within the EU. Where cross-border holding of securities is less attractive than purely domestic securities holding (because it is more cumbersome or even impossible to exercise rights or benefit from them) the financial market will remain fragmented.

However, it is important to note that processing of corporate actions in most Member States is left to market practice which means it is a variable cost factor. Imposing the processing of additional corporate actions will necessarily increase cost and would, at the same time, degrade business opportunities for account providers which are ready to offer a prime service to their account holders with respect to corporate actions. Therefore, any legislative effort would have to provide for the necessary harmonisation in order to make cross-border holding attractive while at the same time limiting itself to a core set of corporate actions in order to leave room for account providers to offer their services on a contractual basis.

14.3 Account providers' duties regarding the "processing" of corporate actions

The notion of "processing of corporate actions" is very broad and even diffuse. It means the participation of an account provider in the process of exercising rights attached to the securities. In what this participation consists depends heavily on two factors:

- First, it depends on the type of right that is to be exercised. For example, it is obvious that the collection of dividends requires an action that is totally different from participating in a shareholders meeting on behalf of the investor.
- Second, the legal holding situation has a great influence on the quality of the action required from the account provider. For instance, as shown in the context of Recommendation 13, the investor, under certain constellations of holding, does not have direct access to the issuer, for instance because the law regards the account provider as legal owner. In order to vote, in this case, the account provider might need to give a power of attorney to the investor and provide a certificate in this regard. In other cases, where the investor is recognised as the legal owner, the account provider might be called upon communicating his name to the issuer in order to make the investor receive a personal invitation to the general meeting where he can vote.

This shows that there is a huge variety of activities that an account provider might need to take in order to "process" a corporate action. The various activities can be classified in three following categories.

14.3.1 Passing on information by the account provider

The first category is the passing on of information in cases where the investor needs certain information in order to be able to exercise a right flowing from the security. For example, he needs to be informed about the possibility of a conversion of the security in order to opt for it or not. However, due to the lack of legal rules and market standards, it is regularly not clear which kind of information has to be passed up and down the holding chain, in particular across jurisdictions. Therefore, this issue is often agreed on in the contract between the account holder and the account provider.

First, there is the question of whether there is a risk that too little information is passed through the chain. It is important that all information vital for the life of a security is exchanged. As regards information destined to the investor, the corporate or commercial law obliges the issuer to make this information available; without such an act, the corporate action does not even come into life. As regards the cases where information has to be channelled from the investor to the issuer, conversely, it is the latter's duty to make the information available. As a result it can be stated that the matter of making the relevant information available is in the hands of the investor and the issuer and is therefore not a subject associated to the channelling of information through the chain.

The problem lies rather in the second question of which information has to be transported and which has not. The likely scenario is that there is a lot of information available, in particular on the side of the issuer, either because the issuer itself releases it, or it is available via other means, e.g. account providers' own research, general media reports, credit rating or market data agencies, etc. Against the background of cost and practicability, it is obvious that account providers cannot channel *all* information to investors and that investors should not be entitled to receive this information. Therefore, the information that is to be processed through the chain of account providers is limited by the following criteria:

- Account providers are bound to transport information that they receive through the holding chain; for the upmost account provider this means information received from the issuer (the issuer itself being bound to publish, by various means, certain information under the applicable corporate law, including information required in the framework of the Transparency Directive or the Shareholders' Rights Directive[47]); for the account provider on the lowest tier this means information obtained from the investor. All other sources of information, including own research results, are irrelevant in this respect.
- Account providers have to channel information that is required in order to exercise a right enshrined in the security. This criterion excludes information like profit warnings, bulletins regarding a changing of the board, investors' statements directed to the annual general meeting, etc. Such information, though sometimes even economically important, is technically not required to enable the investor to exercise corporate rights. For example, an investor can vote at the general meeting regardless whether he has obtained any economical data beforehand.

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[47] *Cf.* Articles 5, 6(4) and 14(2) of the Shareholders' Rights Directive; Articles 4-6, 16-18 of the Transparency Directive.

- The information must be important for the exercise of rights enshrined in the security that exist vis-à-vis the issuer. Information on rights against other persons, in particular fellow investors, would be too specific. Therefore, there should be no obligation to channel such information through the holding chain.
- The information should be of such kind that it is targeted to all investors in securities of the same description. This means that only "standard" information needs to be processed through the holding chain. This is to exclude that investors make use of account providers in the context of individual actions against issuers, in particular in the context of court proceedings, in order to obtain relevant information.

It should be noted that obligatory processing of information by account providers not only might create additional cost but could also trigger an increased liability risk. In particular in the context of takeover bids or similar offers any information that is incorrectly processed might entail a huge liability risk given that the reversal of such transactions, once concluded, would be impossible.

14.3.2 Facilitation of exercise of rights by the account provider

The issue of facilitation of exercise of rights attached to securities is very closely neighbouring the subject of channelling information through the holding chain. Both aim at making the exercise, by the account holder, of the relevant rights possible. The main difference is that in case of information the action required by account providers is a pure transport of what the issuer or investor has made available, i.e. the piece of information. In the case of facilitation, however, the account provider has to take an action in its own authority, for example provide for a prove that the investor actually holds a certain number of securities, or, providing him with a document stating that he would act as a proxy for the account provider (in cases where the account provider is the legal owner of the securities, *cf.* Recommendation 13, *supra*).

One important matter will have to be considered: in the scenario of a cross-border holding chain involving account providers which are subject to the framework of a non-EU country, the exercise of rights attached to the securities can be extremely difficult due to legal or operational obstacles. In such case it might be inappropriate to hold the investor's account provider liable in terms that it would be obliged to make the exercise of rights possible *at all cost*. It is unclear to what extent it should be bound by law to shoulder such important difficulties without receiving appropriate compensation. Therefore, the legislator should consider whether the duty to facilitate the exercise of rights should be made subject to feasibility and contractually agreed levels of service.

14.3.3 Obligatory exercise of rights by the account provider

Obligatory exercise of corporate rights by account providers is important where the investor is not in a position to exercise the rights in person, in particular because the legal make up of the holding chain gives him no direct position *vis-à-vis* the issuer, *cf.* Recommendation 13, *supra*. However, it is important that the investor is in a position to direct the exercise of the relevant right by his account provider by means of instructions. Account providers should be bound to administer such instruction and exercise the right. Yet, this obligation should only exist with respect to the most fundamental rights of an investor which immediately affect the life of a security.

Therefore, the minimum scope of obligatory exercise by the account provider should include

- corporate actions which entail changes of the asset itself, in particular splits, reorganisations, conversion;
- the collection of dividends and other payments and subscription rights; and,
- the acceptance of takeover bids and other purchase offers.

Other corporate actions should be left outside the obligatory minimum scope, e.g. exercising of voting rights or other rights in or with respect to shareholders' meetings, exercising of rights in class actions, etc. However, the account holder is always free to mandate the account provider to exercise such rights on a contractual basis.

Part III
Restrictions on the location of securities (Barrier 9)

The Giovannini Group identified, under the rubric Barrier 9, restrictions regarding the location of securities as limiting on the choice of investors and issuers and as being contrary to the principles underlying the internal market for financial services. The restrictions reflected the evolution of historically efficient national structures but were difficult to justify in the context of an integrated EU financial system. As a pre-condition, therefore, for marked-led integration of the EU post-trading environment[48], they should be removed.

These restrictions came in the form of either market rules or national law. Two types of restrictions could be found: requirements that issues in securities listed in regulated markets were deposited exclusively in settlement systems local to those markets; and requirements that securities listed on a regulated market be submitted to registration with a local registrar for purposes of holding of the issue. These are exemplified as follows:

- *Belgian issuers are by law required to issue dematerialised equity securities into entities which have been designated by Royal Decree as settlement organisation for dematerialized equities. Currently only one Belgian CSD has been designated for these purposes. Consequently, issuers are only able to choose another CSD if the CSD is obtaining a similar designation by Royal Decree.*
- *A Finnish company transforms into a Societas Europea (S.E.) under Luxembourg law and decides to move its headquarters to Luxembourg. Its dematerialised securities (dematerialisation is compulsory in Finland) are registered with the Finnish CSD and traded on the Finnish Stock Exchange. The company wants to maintain this. However, in contrast to Finland, legislation in Luxembourg requires the securities being held in registered form or being represented by a paper certificate. Consequently, a device had to be developed to allow for continued listing and depositing in Finland whilst having securities of a type that Luxembourg law recognises as being issuable by Luxembourg companies.*

The Second Giovannini Report already indicated that there was a link between the matter of restriction of the location of securities, and impediments to the free choice of the location of clearing and settlement of securities (Giovannini Barrier 2). It set out that the logic in restricting the *location of clearing and settlement* originate from restrictions on the *location of securities*. Consequently, the removal of Barrier 9 was a pre-condition for market-led integration of the EU clearing and settlement environment. The EU Commission confirmed this view in its 2004 Communication, stressing that market integration could only be achieved if the whole variety of options for cross-border clearing and settlement were available. Competition could only become fully operational when market participants had full choice on how to clear and settle cross-border transactions, which also required the removal of Barrier 9; and it stressed the important role of competition law in this context.[49]

The matter of improved cross-border clearing and settlement has been addressed by the MiFID and the European Code of Conduct for Clearing and Settlement[50]. The scope of

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[48] First Giovannini Report, pp. 49 *et seq*.; Second Giovannini Report, p. 18 *et seq*.; *cf.* Commission 2004 Communication, pp. 25 *et seq*.

[49] Commission 2004 Communication, pp. 8-9.

[50] European Code of Conduct for Clearing and Settlement, of 7 November 2006; Access and Interoperability Guideline, of 28 June 2007.

Articles 34 and 46 of the MiFID and of the provisions contained in the Code of Conduct are consequently perfectly consistent with the dismantling of Barrier 9.

The MiFID gives investment firms and exchanges a right to choose their post-trading arrangements. More specifically, Article 34 of the MiFID grants to investment firms the right to access post-trading arrangements cross-border, and grants to exchange members the right to designate their settlement system freely. Both rules are conditional upon the existence of the necessary links between the relevant infrastructure and upon approval by competent authorities. Article 46 of the MiFID gives regulated markets the right to set up agreements with post-trading infrastructures in other Member States. Authorities can only override an exercise of this freedom of choice if demonstrably necessary to maintain the orderly functioning of the relevant regulated market.

The Code of Conduct aims at rendering effective the above-mentioned choice for the users of post-trade infrastructures. To this end, it sets up a framework for establishing links – either by means of access or by means of interoperability – between post-trading facilities in foreign markets. The accompanying *Access and Interoperability Guidelines* sets out detailed rules and procedures governing how infrastructures manage to link requests amongst post-trading infrastructures.

The MiFID and the Code of Conduct will thus enhance the possibility to choose post-trading arrangements cross-border. However, the issue of Barrier 9, restrictions on the location of securities, is not addressed as such. Many links established under MiFID and the Code of Conduct will wholly or partially remedy drawbacks flowing from restrictions of the location of securities but without the proper dismantling of Barrier 9 itself, however, the picture remains incomplete for the following reasons:

- first, even if links are in place (and it is impossible to predict how far the coverage will reach), the resulting holding structure would in most cases be more complex when compared to a situation where securities are immediately issued in the relevant market;
- second, the relevant rules of the MiFID and the Code of Conduct are measures addressed to account providers; however, the main purpose of the removal of Barrier 9 is to give *issuers* the choice of the location of securities and thereby ensure competition with respect to the relevant service offerings;
- third, the prerequisites for market-led integration of the EU post-trading environment are not fully met as long as Member States tie the issuance of securities to domestic entities. In such a scenario the integration of systems would exclusively happen through enhanced links between infrastructures, whereas fragmentation of infrastructures as such would inevitably persist. Accordingly, the presence of Barrier 9 mitigates the efficiency benefits of MiFID and the Code in stimulating competition, as post-trade infrastructures would be severely hampered to consolidate.

Recommendation 15 – Initial entry in any Member State

15.a Securities constituted under the law of a Member State should be capable of being initially entered into holding and settlement structures for securities, in particular those maintained by a central securities depository, in or governed by the law of any Member State.

15.b The law of Member States should allow an issuer 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 any Member State. To this end, rules should be abolished that explicitly or implicitly prohibit or impede such initial entry, as for example:

- rules requiring securities to be initially entered into a local holding and settlement structure;
- rules requiring securities to be registered with a local registrar; or,
- rules requiring securities to be acquired and disposed of through a local holding and settlement system.

15.c The law of Member States should allow for holding and settlement structures for securities, in particular those maintained by a Central Securities Depositories, to be open for securities constituted under a law different from the law governing the initial entry into such structures. This concerns for example the following rules which should be abolished:

- rules requiring securities which are not constituted under the local law to have the same form (dematerialised or certificated) as local securities; or,
- rules that apply discriminatorily against securities which are not constituted under the local law with regard to holding, acquisition and disposition.

15.1 Backgound

The title given to Barrier 9 by the Giovannini Reports was "removal of restrictions regarding the *location of securities*". As the scope of Barrier 9 clearly comprises both certificated and dematerialised securities, there is agreement that “location” should not necessarily be understood in the sense of location of a tangible asset. Rather, the matter focuses on the entering of securities (both dematerialised and certificated) into the circuit of holding and settlement through securities accounts by way of making book-entries. The act of entering securities into the relevant structures for holding and settlement by book-entry is regularly confined to the top-tier account provider, in particular the Central Securities Depository (hereinafter "CSD"). Modern account structures are built on the operation of an electronic IT system, which means that the initial entering into the structure for holding and settlement is regularly effected by means of making an initial electronic book entry in the IT system of the top-tier account provider, entrusted by law with the central function of ensuring the integrity of the issue and the reconciliation process. This initial book entry stands for a securities issue.

15.2 Initial entry

Against the background of the above it seems appropriate to speak of the issuer's choice as a choice of the place of the initial entry into holding and settlement structures for securities. In the great majority of cases a CSD is the relevant point of entry. However, in some jurisdictions and for specific types of securities, account providers which are not a CSD, but are legally entitled to perform a functional role identical to a CSD, can act as the top tier of the holding chain. The activity of such top-tier account providers falls equally within the

scope of the present Recommendation under the condition that they do not act as a mere issuer registrar or in a similar function as provided for by the applicable corporate law.[51] It is worth noting that, from a regulatory point of view, it might be advisable to entrust CSDs with the function of entering securities into the circuit of holding and settlement.[52]

Going more into detail regarding the initial entry, two main different characteristics can be identified: in the case of certificated securities, the certificates would be physically deposited in the vaults of a CSD and the number of book-entry securities created would be equal to the number of certificates received. This scenario applies to both the case of newly issued certificated securities and the case where certificated securities had already been held by investors and are only entered into the CSD at a later stage. In the case of dematerialised securities, the securities may not exist before and, insofar, as securities are not created previously in dematerialised form in an electronic register, the initial entry does not merely *introduce* the securities into the holding structure in the proper sense; rather, in most jurisdictions[53], the initial entry *creates* the securities at that point in time.

The difference between these two different peculiarities shows that the initial entry of securities into holding and settlement structures is very close to their creation and consequently to core corporate law. Therefore, there need to be a clear delimitation as to which steps within the process of "coming to life" of securities are actually addressed by Barrier 9 and which steps are not.

15.2.1 The four steps to make an issue available to investors

In the process of introducing securities into the holding and settlement circuit, a sequence of formal steps is performed by the issuer and (by his order) by other persons, such as, for example a notary and a CSD. Additionally, in particular in the case of shares, publicity of the new issue is ensured by an entry in a public register or the like. Some of these steps belong exclusively to the sphere of the creation of securities, i.e. in particular to core corporate law in the case of shares, and remain outside the scope of Barrier 9 which is dedicated to allowing for a choice of the holding and settlement structures. Other steps, however, clearly belong to holding and settlement. Consequently, the question is whether a clear line can be drawn between the two spheres of creation on one hand, and holding and settlement on the other; and, if so, where to draw it.

The present *Advice* analyses the process of issuing securities from a functional perspective. To this end, the various steps of the process to be performed for different types of securities in different Member States are categorised according to their function. The result of this analysis

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[51] For convenience, reference is made, throughout the further text of this recommendation, to "CSD" only.

[52] *Cf.* CPSS-IOSCO Recommendations for securities settlement systems of 2001, Recommendation 6 in particular; Standard 6 of the pending ESCB-CESR standards for securities clearing and settlement in the European Union of 2004.

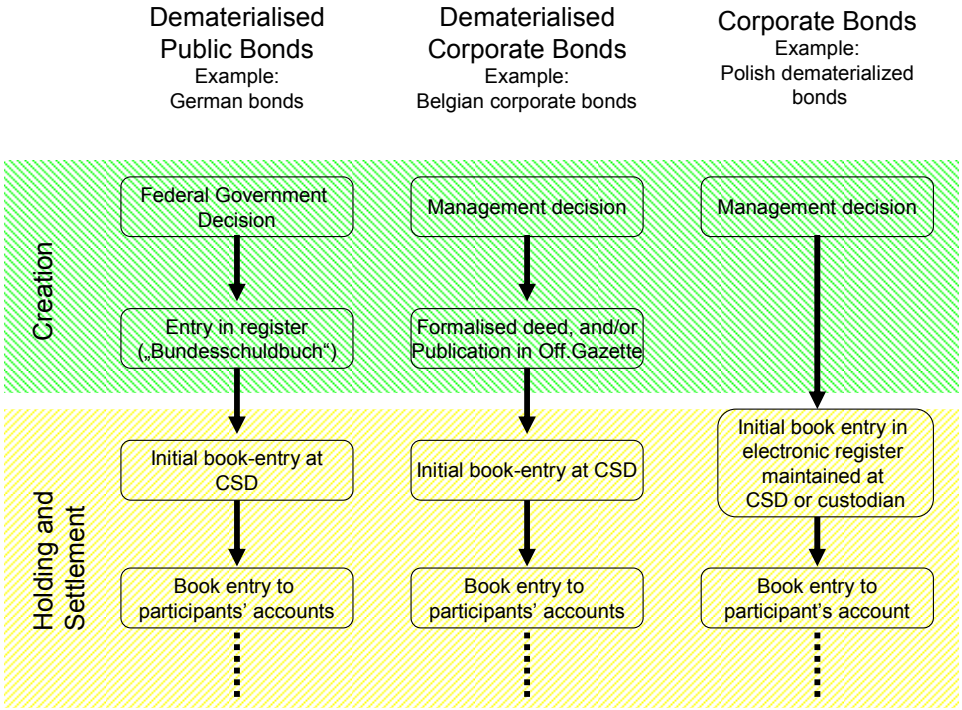
[53] However, the initial book-entry or the effected security certificate to not have a constitutive effect in all Member States: (a) Under French law, the securities are only created at the point in time at which they are credited to a securities account (the account in the CSD being the custodian ledger). (b) In the United Kingdom, where equity securities are created in book-entry form on accounts maintained by the issuer itself, and subsequently (especially if a public offering is intended) entered onto the books of a CSD, in which narrow sense the initial entry in the CSD post-dates, rather than creates, the existence of the securities. For the purposes of this *Advice*, such securities may be analysed in every respect with other dematerialised securities. (c) Under Bulgarian and Greek law, securities exist even before a certificate is effected or a book-entry is made.

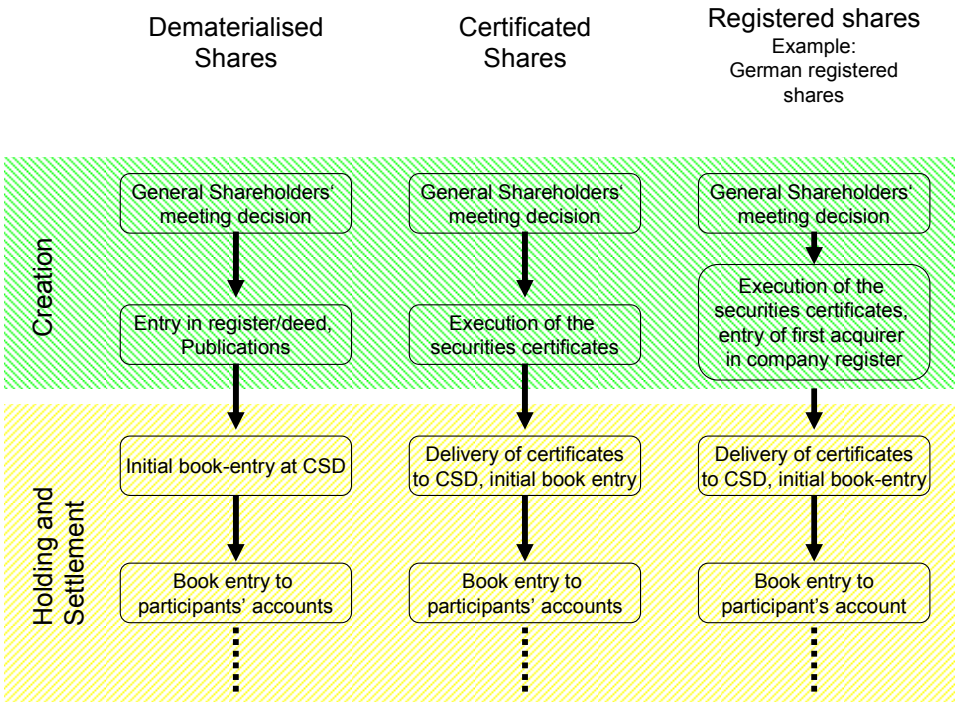
is a clear parallelism of functional steps. It can be noted that distinctive elements playing an important role in other contexts (i.e. class of assets: shares, mutual fund shares or bonds; dematerialised or certificated; bearer or registered) do not play a decisive role in respect of the present subject matter.

Broadly, the sequence of steps is as follows:

1. a decision by the issuer is taken, following the relevant rules of corporate law or commercial/civil law respectively;
2. formal steps required by corporate, commercial, civil or public law are to be fulfilled, in particular concerning notarisation, publicity, etc.;
3. the securities issue is introduced into the CSD by the issuer or its lead manager, the CSD registers the issue for purposes of book-entry holding and settlement and makes an initial book entry;
4. the CSD channels the securities by book entry on the orders of the issuer or the lead manager down to its participants or account holders and subsequently down to the investors (to the extent they are not the investors themselves).

As mentioned before, the scope of Barrier 9 relates exclusively to the choice of the place of the initial entry into the holding and settlement structure. Elements that form part of the process of creation of securities and belong to core corporate law should be unaffected by measures aiming at dismantling Barrier 9. Thus, all steps where there is no connection to holding and settlement are outside the scope of the present exercise. It is obvious that the issuer's decision-making (step [1.], above) and the formalisation (step [2.], above) belong to the process of creation, whereas the spreading of the securities through the network of account providers down to the investors (step [4.], above) clearly forms part of the world of holding and settlement.





15.2.2 The function of the CSD at the borderline between "creation" and "holding and settlement"

Consideration needs to be given to the function of the CSD described in step [3.] above. At first glance it is unclear whether the parts of its intervention in the process either belong to the category of creation of securities or rather to the sphere of holding and settlement:

15.2.2.1 Delivery and entry into custodian ledger

The first function of the CSD is to make an initial book entry, which serves as counter account (also called "custodian ledger") with respect to the credits of the newly issued securities to the securities account of the CSD's participants in the issuance process. In most jurisdictions, the relevant account is, however, not regarded as an account for the purpose of securities holding and settlement. Consequently the book entry in question does not have the same quality as book-entries generally referred to throughout this *Advice*, in particular in Part I. This initial credit can have three different roles.

- evidencing the receipt by the CSD of the securities delivered by the issuer (which is the case in particular for certificated securities). From a functional point of view, this step seems to be rather a measure of internal book-keeping. However, in some jurisdictions, it might be part of the process of creating securities, because creation requires as final step, the delivery of the securities to a person different from the issuer;

- materialising the creation of the securities for the first time, in particular in the case of dematerialised securities. Here, the initial entry into the books of the CSD may equally appear as last step in the process of creating securities;
- creation of a pure custodian ledger for the purposes of reconciliation, whereas the dematerialised securities are created at a subsequent stage by the credit to a securities account.

15.2.2.2 Reconciliation

The second function is reconciliation, sometimes also termed "notary function": for securities kept and processed in holding and settlement structures, the CSD has to guarantee the existence, the description and the amount of the securities originally introduced in that structure by the issuer or by the lead manager on the issuer's behalf. This function is crucial for the integrity of the issue, systemic stability and consequently is a necessary precondition for investor protection. It is common to all systems and supported by an ongoing duty to reconcile the total amount of the relevant securities credited in the system with the number of relevant securities kept in the CSD for the issuer. However, the term "notary function" appears to be misleading with respect to the CSD's actual role which remains an operational, albeit very important, one. The fulfilment of this duty cannot be guaranteed by assimilating the role of a CSD to the one of a notary; rather, clear regulatory requirements and supervision of the activity by a competent authority are key. Hence, reconciliation does not belong to the process of creation of securities, but rather to the sphere of holding and settlement.

15.2.2.3 Assessment

There are jurisdictions where the first function (i.e. delivery to the CSD or the making of the initial entry in the system) forms part of the creation of securities. The second function (reconciliation), however, belongs clearly to the sphere of holding and settlement of securities. Yet, the present *Advice* advocates the inclusion of <u>all</u> CSD functions in the scope of Barrier 9, for the following reasons:

- if the scope were to comprise only the reconciliation function, as well as the task to spread the securities issue through the holding chain down to the investors, the initial entry could still be tied to the issuer's home jurisdiction; this would eliminate most of the benefit envisaged by the dismantling of Barrier 9;
- the various functions of a CSD would be difficult to split from an operational point of view;
- under the assumption that the complete activity of a CSD would be included in the scope of Barrier 9, the extent and the nature of the encroachment on corporate law would still be acceptable. Only the very last step of the coming into life of securities would be affected. Core corporate law is not concerned, as the content of the securities, as well as all other formal steps would entirely remain governed by the law of the issuer's jurisdiction. The national corporate law would only need to recognise that a valid initial delivery can be made to any CSD in the EU, and/or an initial entry could be made by any CSD in the EU respectively.

However, some voices emphasis the potentially important impact of including the complete function of the CSD on fundamental legal concepts, in particular in the field of corporate law and more specifically related to the question of what constitutes a security, notably a dematerialised security, adding that there was the need of additional exploration of the feasibility under the Member States' corporate law.

Following the majority of contributors, the present *Advice* is based on the understanding that the full spectrum of activity of a CSD, in the context of entering securities into the holding and settlement structure, is included in the scope of Barrier 9.

15.2.3 Shift of an issue

Against the background of the aims of Barrier 9, the scope of this analysis might comprise the matter of issuers planning to move the issue from one jurisdiction to a different jurisdiction and a different top-tier custodian *at a later point in time*, by taking the securities out from the first CSD and asking a second CSD to make a new initial entry. For example, this could be interesting in cases where the second CSD offers more favourable terms of business than the first one.

Example 45: The bonds of Issuer X are kept in the CSD of A-Country. The CSD of B-Country offers the same service at considerably lower cost. The issuer wonders whether it can get the securities out of the CSD in A-country and introduce them into the CSD of B-Country.

This example shows that there might be a business case for shifting a securities issue from one jurisdiction to another. Certainly, many operational issues have to be taken into account, for example the question whether the ISIN number would remain unchanged. In the context of Barrier 9 it is important to note that a subsequent shift from one CSD to another CSD might be the choice of the issuer; however, existing investors would be affected as the move of the place of the initial entry to another jurisdiction inevitably entails changes to the legal position of the investors. The latter acquired the securities at a point in time when they were held with a specific top-tier account provider. The legal regime applicable to so-called "proprietary issues", like acquisition and disposition (*cf.* Part I, above) would change according to the applicable conflict-of-laws rules. This change in the investors' position seems difficult without the consent of the latter, to be given in accordance with the rules governing the issue.

It is true that, based on the assumption that Barriers 13 and 3 would be entirely resolved (*cf.* Parts I and II), the investor's minimum rights as granted under Recommendation 4, and re-inforced by Recommendation 13 and Recommendation 14 would not change. However, the *legal* make-up of the holding would be changed, because the law of a different jurisdiction would apply to acquisition and disposition. Yet, if such decision were to be validly taken by the issuers on the basis of the law under which the securities are constituted, a shift of the issue from one CSD to a CSD located in another Member State should, in principle, be possible, although further harmonisation of Member States' law would be beneficial in this respect.

15.2.4 Split of an issue

A limited number of securities in the EU, namely Eurobonds, are held through more than one top-tier custodian located in the EU. Against this background and taking into consideration that an issuer might wish to be directly present on two or more markets, there is the idea of generally allowing issuers to split an issue between more than one CSD. However, this might give rise to increased uncertainty, as the reconciliation of the total amount of securities issued with the total amount of securities circulating in the two or more top-tier holding and settlement structures would become more complex. This appears to be possible only if, either, a cross-border IT platform were to be set up, or, arrangements were made similar to those used for Eurobonds at present, i.e. the various parts of the issue kept in different top-tier account providers are held through a common sub-custodian, or a so-called “Common Safe-Keeper”. Hence, there is actually no split of the place of the initial entry. Consequently, future

European legislation can disregard the scenario of splitting the location of securities from a legal point of view, as in case of need, the existing framework can accommodate such a situation.

15.3 "Exportability" and "importability"

There is an important dichotomy described in the present *Advice* by the shorthand of "exportability" and "importability": restrictions to the free choice of the location of securities can originate from two sides, because

- on one hand, the law under which securities are constituted might require that the initial entry of securities into the structure for holding and settlement be effected by a local CSD, or allow for other than legal rules to aim at such a restriction (restriction on exportability), or
- on the other hand, the law of a Member State might restrict the ability of a local CSD to make an initial entry into the holding and settlement structures with respect to securities which are constituted under the law of another Member State, or allow for other than legal rules to aim at such a restriction (restriction on importability).

As regards the existence of restrictions relevant in the context of Barrier 9, the present *Advice* draws on the survey undertaken in 2006, by the Legal Certainty Group, under the rubric of Question 38[54].

15.3.1 Restrictions regarding exportability

Restrictions on exportability hinder an issuer's free choice of CSD. Provisions of the law under which the securities are constituted (or other measures under that law), make it impossible, cumbersome or more expensive to arrange for the securities to be initially entered into a holding and settlement structure which is governed by the law of another Member State. The Comparative Survey revealed the existence of at least the following categories of restrictions:

15.3.1.1 Listing tied to local CSD

There are many examples where the listing on the local stock exchange requires the securities issue to be entered into the holding and settlement structure of the local CSD. This phenomenon applies to both certificated securities issues and – mainly – to dematerialised securities issues.

- *In Poland, securities which are admitted to public trading have to be registered in a Polish CSD.*
- *In Finland, companies which are incorporated under Finnish law and which are listed on a Finnish regulated market are required to dematerialise their shares and arrange for them to be held in the book-entry system maintained by the Finnish CSD.*
- *Latvian Government bonds must be initially entered into the Latvian CSD.*

15.3.1.2 Settlement tied to local SSS or local registrar

A second type of restriction of exportability is the requirement to settle acquisitions and dispositions exclusively through accounts which form part of the local securities settlement

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[54] Cf. Comparative Survey/Questionnaire, 24.04.2006, Question 38, pp. 424-438.

system. Similarly, in other Member States, the settlement of securities is tied to a local registrar.

- *Belgian Government bonds which are issued in dematerialised form have to be kept on accounts with authorised account holders in the Belgian CSD that has been designated by law as a settlement organisation for these securities.*
- *In the United Kingdom, shares are constituted by a register, which must be kept within the United Kingdom.*

15.3.1.3 Dematerialisation tied to the local CSD

In some Member States, dematerialisation of securities is mandatory; in other Member States it is an option for the issuer, or for example linked to listing at the local stock exchange. In both cases, the initial entry of the securities into the holding and settlement structures is often tied to the local CSD, *cf.* above, section 15.2.2.

- *German dematerialised Government bonds are to be issued into a "Wertpapiersammelbank" (CSD) in the meaning of the German Securities Deposit Act. At present, only Clearstream Banking Frankfurt and the ECB fulfil the requirements to be designated as Wertpapiersammelbank.*
- *Slovenian dematerialised securities can only be issued via registration in the domestic register, operated by the domestic CSD.*

15.3.2 Restrictions regarding importability

Restrictions on importability equally limit the issuer's choice of the CSD which makes the initial entry. But unlike the case of exportability, it is the law governing the CSD which hampers free choice by setting entry requirements which cannot be met or are cumbersome or more expensive to meet by foreign securities issues.

15.3.2.1 Certification - dematerialisation

Some Member States' law might either require dematerialisation of all types of securities or rely on the issuance of a paper certificate for some or all types. Others might give issuers a choice, or impose certification for some types of assets whilst making dematerialisation mandatory for others. Both debt instruments and shares are equally subject to these differences regarding dematerialisation and certification. Consequently, when issuing cross-border, the variety of solutions might lead to incompatibilities in the sense of Barrier 9. In the first possible scenario, both the law under which the securities are constituted, as well as the law governing the CSD where it is envisaged making the initial entry, are based on the understanding that securities are dematerialised; consequently, the aspect of certification/dematerialisation is not problematic. In the second possible scenario, the law under which the securities are constituted requires the issuance of dematerialised securities irrespective of the place where the initial entry is made. The law governing the CSD does not recognise securities in dematerialised form; consequently, there is a clear Barrier 9 restriction.

- *If a Spanish issuer decides to issue shares in a foreign country, the foreign CSD might require compliance with local regulations, often entailing the issuance of a "certificate" embodying the number of securities issued, and following a certain format required by local rules; however, this type of certificate is not foreseen under Spanish law.*
- *Under Czech law, there is the exceptional case of compulsory dematerialisation of shares in banking institutions; a substitute certificate for issuing abroad is not available.*

The third scenario is the inverse case: the law under which the securities are constituted requires issuance of securities certificates (at least in the case where the issue is to be initially entered into holding and settlement structures abroad, as for example under Czech law). The

law governing the CSD only provides for a holding and settlement system based on the existence of dematerialised securities.

Admittedly, both the second and third scenarios are cases of restrictions regarding exportability and importability at the same time, as both jurisdictions require one form and do not accept the other.

15.3.2.2 Risk of discrimination

Another restriction of importability arises where the law governing the CSD treats securities which are constituted under a different law less favourably than domestic securities, or there is a risk of this happening.

- *Because it is unclear on this specific point, Polish law on trading in financial instruments might be interpreted in such a way that only those firms which keep securities accounts as defined under the Polish law are entitled to issue valid certificates to their customers.*

15.3.3 Justification of certain restrictions?

There are recurring arguments aiming at justifying the imposing or maintaining of restrictions in relation to the place of initial entry into holding and settlement structures.

First, there is the argument that compulsory delivery into or compulsory registration with the national CSD would guarantee coherence of the issue. In particular, the risk of inflation of the number of securities or the loss of securities would be avoided more successfully than would be possible in a holding pattern which involved entities spread cross-border. This argument is also used in referring to specific assets (like for example parts in mandatory pension funds), the safeguarding of which is a very sensitive issue. However, the present *Advice* does not follow this point. An EU integrated post-trading environment can only exist on the basis of a common high standard of operational and legal certainty in post-trading operations. The risk of loss of securities, or of similar incidents, is no more likely in some Member States than in others. Not least, the implementation of the work of CESAME, as well as the present *Advice,* will remove remaining legal and operational uncertainties relating to cross-border holding and settlement.

Furthermore, there is the perception in some Member States that restricting competition between CSDs would actually increase transparency, safety and soundness of the post-trading landscape. It is clear that such an argument does not comply with the principles of the EU internal market.

With respect to Government bonds, there is the argument that it was not opportune to classify measures like the ones described above as restrictions in the sense of Barrier 9. This was because the issuer itself (the Government) chose to bind a securities issue to a local CSD. However, the present *Advice* would not follow this opinion for two reasons: first, it is not said that in all cases the authority imposing such restriction is the same authority that issues the securities, in particular in federal countries; second, Barrier 9 comprises equally a competition element, enabling CSDs to offer their services freely to all issuers within the EU.

Lastly, regarding tax procedures, reference is often made to the crucial role of CSDs in the collection of taxes, especially withholding tax; the close interaction between fiscal authorities and the CSD could only be guaranteed if the CSD was the local one. Again, the present *Advice* advocates that, against the background of the principles of the internal market for financial services other measures (as, for example, reporting mechanisms) could be used to achieve an identical result. Restricting the choice of issuers and competition between CSDs is unnecessary to ensure proper functioning of tax procedures.

The present *Advice* recognises that, originally, there might have been justified motivations behind the aforementioned restrictions. However, the standard of operational and legal certainty is such that, in the modern pan-European post-trading landscape, restrictions like the ones described above are unjustified and contrary to the principles of the internal market. Not least the implementation of the Recommendations of Part I of the present *Advice* will be instrumental in further improving operational and legal certainty in this regard.

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