

11 June 2009

## **Legislation on Legal Certainty of Securities Holding and Dispositions:**

### **Consultation document of the Services of the Directorate–General Internal Market and Services**

The European Securities Services Forum (ESSF)<sup>1</sup> is pleased to respond to the European Commission's consultation document on the necessity to improve the EU wide legal framework for securities holding and disposition and on how future EU legislation in this field could address the issue.

In the first section of our response, we provide the requested 'Information on the Respondent'. Section 2 set out our general comments on the need for and required content of EU law reform on the holding and disposition of securities. In the third section, we respond to the questions of the Questionnaire

#### **1. Information on the Respondent**

- A) The ESSF is an affiliate of the Securities Industry and Financial Markets Association (SIFMA) domiciled at St. Michael's House, 1 George Yard, 2<sup>nd</sup> Floor, London, EC3V 9DH.
- B) Industry representation – representing the interests of major users of post-trade securities services in Europe.
- C) ESSF does not conduct securities operations in the EU/EEA area.
- D) ESSF is not a securities account provider
- E) ESSF represents approximately 15 members (list of members attached).

#### **2. Introductory Remarks**

In essence, it is the view of ESSF that:

- the highly desirable law reform in relation to the legal effects of book entries should concur to the highest possible extent with the UNIDROIT Convention on Substantive Rules regarding Intermediated Securities;
- the harmonisation of both substantive law and conflict-of-laws at European and international levels are essential for an optimal functioning of post trading;
- the recognition of different holding structures (including nominee and omnibus accounts) are indispensable to achieving increased efficiency and cost effectiveness;
- legislative measures that are intended to achieve objectives *other* than the removal of legal barriers to post-trading, such as shareholder transparency for

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<sup>1</sup> The ESSF is the European post trading centre of competence of the Securities Industry and Financial Markets Association (SIFMA). Our members are the major users of international securities markets. Representing its members as towards market infrastructure organisations and public authorities, the ESSF acts as an agent for change providing and supporting solutions in the securities clearing, settlement and custody space to reduce risks and costs to market participants.

issuers, should not be part of this harmonised legal framework for intermediated securities.

### **3. Responses to Consultation Questions**

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

Answer:

As an industry organisation representing the interests of major users of post-trade securities services in Europe, the ESSF does not have direct access to reliable estimates of percentages of securities not held through a securities account. However, exchange traded securities in most European markets are generally or fully dematerialised or immobilised and thus held through a securities account. Even where this is not (yet) the case as e.g. in the UK retail market, dematerialisation initiatives are under way.

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

Answer:

Yes, considerably more complex. This increased complexity stems predominantly from the creation of collateral interest, when collateral provider, collateral receiver, collateralised assets, collateral agreement and/or secured obligations are in different jurisdictions or are governed by different sets of rules.

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

Answer:

Yes. Already back in 2002 in a wide consultation of its membership, ESSF identified harmonisation of legislation in the post-trade area as the single most important aspect to increase efficiency in the cross-border securities services market. The ESSF supports the principle of limiting the scope of harmonised European legislation to the provision of legal certainty to the account holder as to the extent to which an acquired position can be used. The exact legal characterisation of the acquired position is left to be determined by Member States.

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

- (a) *the right to exercise and receive the rights attached to the securities, as far as the account holder itself is identified by the issuer law as the person entitled to these rights;*
- (b) *the right to instruct the account provider to dispose of the securities;*
- (c) *the right to instruct the account provider to arrange for holding the securities with another account provider or otherwise than with an account provider, as far as the applicable law allows holding otherwise than with an account provider.*

Answer:

Yes to (a), (b) and (c). In relation to (c) we maintain that the minimum right should accommodate nominee structures (where this is market practice), omnibus accounts, and generally for all the holding patterns referred to in Recommendations 13a and 13b of the Second Advice of the Legal Certainty Group published in August 2008.

We moreover suggest that the direct legal relationship of investors with both CSDs and intermediaries in Nordic markets (direct holding system) is clarified.

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

Answer:

Yes. We believe that the six methods described in Question 5 should be available to market participants throughout all EU jurisdictions. Conceptually, we are uncertain as to whether conclusion of a control agreement and conclusion of an agreement with and in favour of the account provider are actually methods for acquisition and disposition, or are rather to be thought of as methods for determining who has the authority to initiate an instruction to acquire or dispose.

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

Answer:

Yes. We believe that in the absence of such recognition, legal certainty would not be enhanced in any way whatsoever compared to the current situation.

7. *Do you think that future legislation should leave to Member States the possibility of making the effectiveness of an acquisition or disposition subject to a condition contractually agreed upon between account holder and account provider, in particular a condition that a corresponding acquisition or disposition occurs? (Yes/No/I don't know; please specify)*

Answer:

No. We believe that a transparent level playing field should be created. An acquisition or disposition should be effective or not. And the way in which this effectiveness is evidenced should also be harmonised across the EU jurisdictions. We should not end up with a situation wherein crediting, debiting, earmarking or removing of earmarking is unconditional in one jurisdiction and conditional in another.

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

Answer:

Yes. We understand that the position of the account holder has to be protected. The list of conditions for reversal should therefore be as short as possible. It is to be noted that any rule on reversals should not be seen as interfering with the ultimate allocation of liability and/or responsibility for crediting, debiting, reversing or lack thereof. However, such a rule will by necessity allocate the burden of proof for any claim.

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

Answer:

Yes. These criteria (actual knowledge or "should have known") appear adequate to preserve the requirement of good faith for the account holder in whose favour a credit has been made.

10. *Do you think that interests in book-entry securities, notably security interests, which are 'visible' in the account, should have priority over book-entry*

*securities which are not 'visible' in the account? (Yes/No/I don't know; please specify).*

Answer:

We don't know, as it is difficult to foresee how this would work in practice. We are in principle in favour of a system of publicity (such as earmarking) for security interests, but are uncertain how the question has to be interpreted in the context of e.g. floating charges, where the position of the secured creditor should not be prejudiced as a result of the introduction of a publicity rule (without examining the relevant insolvency laws). We note that e.g. with the Financial Collateral Directive, a welcome trend has been created to move away from burdensome formalities for the perfection of a security interest, and it would not be a desirable evolution if this trend were to be reversed.

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

Answer:

Yes. We fully support the principle that the intermediated holding pattern should never give rise a situation wherein more securities are in circulation than the number issued by the issuer. That being said, any legal obligation implementing that principle should not affect the ability of market participants from engaging in legitimate activities including, inter alia, short selling, hedging and/or contractual settlement.

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

Answer:

Yes. Our answer assumes that some sort of book-keeping or operational error can be attributed to the account provider (such as – but not limited to – failure to keep adequate accounting records). National insolvency laws should be allowed to play their full role. E.g. under English law an equitable charge might be cast over a proprietary account to meet the needs of the client account; if that client account is short, then it would probably benefit from a claim against the account provider in the normal course.

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

Answer:

Yes, in certain cases: If there is a shortfall in an omnibus account, then the risk of a shortfall should be shared pro rata (which is the effect of e.g. the FSA Client Money Rules for cash, where a primary pooling event occurs). Segregated clients should not share the burden of a shortfall impacting the accounts of other segregated clients.

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

Answer:

Yes.

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

Answer:

Yes. Harmonisation of both substantive law and conflict-of-laws are necessary for an optimal functioning of a pan-European post-trade market. We are very concerned about the lack of progress in relation to conflict-of-laws issues. There are still no uniform conflict-of-laws rules that govern issues that are of crucial practical importance for the holding and disposition of securities held by intermediaries. Uncertainty in this regard leads to significant expense for market participants and furthermore adds an unnecessary risk to the global capital markets. In our opinion it should be a priority to enhance the international work on predictable conflict-of-laws rules for dematerialised securities.

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

Answer:

Yes. Without having had the opportunity to fully discuss the different conflict-of-laws criteria in the SFD, WUD and FCD, we believe that a uniform approach is desirable, not only within the EU but globally.

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

Answer:

Yes.

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

Answer:

As an industry organisation representing the interests of major users of post-trade securities services in Europe, ESSF does not have direct access to reliable estimates of this additional cost, but has encouraged its members to provide such information directly to the European Commission.

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

Answer:

Yes, considerable difficulties, stemming from time zone differences, translation requirements, legal interpretations and lack of systems interoperability.

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

Answer:

Yes. However, account providers should only exercise membership rights, e.g. participation and voting in shareholder meetings, upon the explicit demand of the investor (and not the issuer) and only in cases where the services provided are inseparably connected to the account provider status, e.g. confirmation of holdings. This excludes services such as proxy voting services for which there is an existing cross border market.

19. *Do you know other cases where assistance of the account provider is a prerequisite for the exercise of the right by the investor? (Yes/No/I don't know; if yes, specify)*

Answer:

In the case of corporate actions (see attached Market Standards for Corporate Actions Processing), in particular elective corporate actions, the role of account providers, as described, is essential for the investor's exercise of the rights flowing from such corporate actions.

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

Answer:

Yes. However this should not be limited to cases where the exercise of the rights by the investor himself is impossible, and it should in all cases be subject to the principle that the account provider acts upon instructions or consent of the account holder or otherwise as agreed between the investor and the account provider. (see also our answer to question 18)

*20b In the affirmative case, do you think that this possibility should be subject*

- (a) To feasibility on the side of the account provider (Yes/No/I don't know, please specify, in particular, the exact scope of such feasibility exemption), and/or*
- (b) To contractually agreed levels of service between the account holder and the account provider? (Yes/No/I don't know, please specify).*

Answer:

Yes.

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

Answer:

No. If the investor does not want to exercise certain rights, that choice is to be respected, and these rights should not be transferred to anyone else without knowledge and consent from the investor.

21b *In the affirmative case, do you think that this possibility should be subject*

- (a) *to feasibility on the side of the account provider (Yes/No/I don't know, please specify, in particular the exact scope of such feasibility exemption), and/or*
- (b) *to contractually agreed levels of service between the account holder and the account provider? (Yes/No/I don't know; please specify)*

Answer: N/A

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

- (a) *Rights entailing a change of the relevant security itself (e.g. conversion, reorganisation) (Yes/No/I don't know; please specify)*
- (b) *Collection of dividends or other payments and subscription rights (Yes/No/I don't know; please specify);*
- (c) *Acceptance or refusal of takeover bids and other purchase offers? (Yes/No/ I don't know; please specify)*
- (d) *Other rights (Please specify which and why)*

Answer:

In general, the account provider should act on instructions by the account holder. In the absence of instructions, the account provider should, in relation to pecuniary rights, act in the best interest of the account holder, and in relation to other rights, abstain from any actions.

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

Answer:

Yes, in the context of distributions and reorganisations to the extent described in the Market Standards for Corporate Actions Processing. In the case of membership rights, i.e. participation and voting in shareholders meetings, if so requested by the investor and agreed in the service level agreement.

24. *Do you think that this obligation should be restricted to information*

- (a) *which is received "through the holding chain", (i.e. directly either from the issuer or an account provider which maintains an account*

*for the account provider in question, or from the investor or another account provider for which the account provider in question maintains an account.) (Yes/No/I don't know, please specify);*

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

Answer

- a: Yes  
b: No

25. *Would you advise other/additional restrictions to this duty? (Please specify)*

Answer:

See our answer to question 23

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

Answer:

Yes.

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

As an industry organisation representing the interests of major users of post-trade securities services in Europe, ESSF does not have direct access to reliable estimates of the incremental cross-border cost for the processing of rights flowing from securities, but has encouraged its members to provide such information directly to the European Commission.

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

Answer:

Yes. We firmly support the principle laid down in Recommendation 15 of the Second Advice of the Legal Certainty Group published in August 2008.

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

Answer:

Yes. We firmly support the principle laid down in Recommendation 15 of the Second Advice of the Legal Certainty Group published in August 2008.

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

Answer:

There could well be such issues, but they should be resolved in order to give full effect to Recommendation 15 of the Second Advice of the Legal Certainty Group published in August 2008.

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

Answer:

In the absence of full implementation of Recommendation 15 of the Second Advice of the Legal Certainty Group published in August 2008, there is no true competition among CSDs, as a result of which costs can be maintained at an artificially high level.

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

Answer:

It is very hard to determine or estimate the level of cost that can be attributed to a less than optimal competitive environment.

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

Answer:

Yes. It does not appear to be justifiable to draw a distinction between securities accounts provided by unregulated providers and securities accounts provided by

regulated entities; therefore all providers should be subject to a harmonised regime of authorisation and supervision, in the interest of a uniform protection of the account holders.

With the development of enhanced access to the securities markets for every investor, the case for distinguishing a securities account from a reimbursable deposit account becomes less strong.

EU rules should facilitate activity by non-EU established entities which are present in the EU and are subject in their local/host activity to authorisation by an EU regulator, on a non-discriminatory basis.

*31b If no: Which account providers should not be subject to authorisation and supervision by competent authorities? (Please designate the type of account provider and specify why)*

Answer: N/A.

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

Answer:

Yes. See our reply to question 31. In addition, it would remove a lot of interpretation questions.

However, some of our members are concerned to ensure that any extension of the definition of investment service to include ancillary service is applied on a non-discriminatory basis, so that institutions based outside the EEA are able to provide the services on the same basis as institutions based within the EEA, and to avoid unnecessary regulatory burdens on providers of those services. Further consultation on any proposals would be welcome.

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

Answer:

No.

#### Attachments

- List of ESSF members
- Market Standards for Corporate Actions Processing

## **ESSF Membership**

Bank of America Merrill Lynch  
Bank of New York Mellon  
Barclays Capital  
Citi  
Credit Suisse  
Dresdner Kleinwort / Commerzbank  
Goldman Sachs  
HSBC  
JPMorgan Chase  
Morgan Stanley  
Nordea  
RBS  
UBS