

Financial Law Committee response to the consultation by the European Commission on legislation on legal certainty of securities holding and dispositions

1. The City of London Law Society (CLLS) represents approximately 14,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.
2. The CLLS responds to consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, has prepared the comments below, in response to the Consultation Document on the above proposed legislation, from the perspective of English law. Details about the membership of the working party are set out on page 40 below. A separate response is being submitted by the CLLS Company Law Committee on those questions which primarily give rise to company law issues. Unless otherwise stated, references in this response to Principles and sections are to Principles and sections of the Consultation Document.

Preliminarily comments

3. We welcome the broad objectives of the proposed legislation and in particular support the aim of promoting an international set of core harmonised rules based on, and compatible with, those of the Unidroit Geneva Convention on Substantive Rules for Intermediated Securities (the "**Geneva Securities Convention**"). There are, however, a number of points on which the proposals are unclear or seem to be inconsistent with the Commission's stated purposes. In particular we consider that:
 - (a) The proposal in Principle 9 to afford an inferior priority to interests created under a control agreement is unnecessary and inappropriate.
 - (b) The proposal in Principle 4 relating to the passing on of costs of a buy-in is unnecessary and inappropriate and likely to cause systemic risk and have a serious adverse impact on the efficiency and integrity of EU securities holding and settlement.
 - (c) The proposals on "ultimate account holders" will need to be considered further and appropriately amended to avoid a conflict where domestic company law (as in the case of the UK) requires the issuer to recognise only the registered holder of securities as the legal holder and also to avoid a conflict with current practices in European bond markets. In addition, Principles 16 and 17 relating to the passing of information and the facilitation of the "ultimate account holder" raise not only questions of operational feasibility but legal concerns (which will need to be

addressed) in the numerous cases where the issuer, one or more account providers or the ultimate investor is outside the EU (the proposals also omit to provide who is to bear the costs).

- (d) The proposed conflict of law rule does not provide the degree of ex ante legal certainty that is required for the efficient and effective operation of the EU markets.
 - (e) The imposition of strict liability on account providers will result in increased costs for EU account providers, and ultimately the users of their services, and potentially a reduction in the scope and nature of the services that EU account providers are willing to provide to account holders.
4. Given the importance of this area to EU investors, financial institutions and financial markets, we suggest that it is especially desirable that the Commission should follow the principles of good regulation by ensuring that its proposals are evidence-based, proportionate and based on proper impact assessment and analysis of costs and benefits. We consider that substantial additional work will be needed to adapt the measures and to assess impact in order to meet these standards as regards the matters specified in paragraph 3 above and a number of other points referred to in our detailed comments below. As a general comment, we are concerned at the extent to which the Commission envisages proposals that would override market forces and freedom of contract. The current arrangements for the holding of securities through intermediaries have evolved through the operation of normal commercial forces. This is in large part because they enable investors to benefit from the efficiency and convenience of centralised professional administration of their investment portfolios while at the same time, by leaving the precise details of the service provided by their intermediary to be settled by agreement, allowing them some choice in balancing the extent of their detailed involvement in monitoring of information and the exercise of rights against the cost of facilitating this. The Consultation Document appears to contemplate, to a very significant extent, imposing a "one size fits all" regime, but without any evidence or explanation of why it is regarded as essential to do this.

Reponses to questions raised in the consultation document

Q1: Do you agree that the envisaged legislation should cover the objectives described above [Principle 1]? If not, please explain why. Are any aspects missing (please consider also the following pages for a detailed description of the content of the proposal)?

- 5. We broadly welcome the proposed legislation. We also strongly support the mandate provided by the ECOFIN Council to the Commission on 2 December 2008 that any proposed legislative measures should bear "in mind the benefits of maintaining global compatibility with other jurisdictions".
- 6. However, as our more detailed responses to the questions below indicate, we have material concerns with a number of the approaches and suggestions contained in the Consultation Document. Our main concerns are as follows.

Inadequate differentiation between account provider models

- 7. The Consultation Document elides two very different types of model for the holding and transfer of securities:

- (a) **immobilisation** - where the account provider will interpose itself in the proprietary chain between issuer and investor;
- (b) **dematerialisation** - where the account provider does not interpose itself into the proprietary chain, with the result that there is no break in the legal relationship between issuer and investor.

Dematerialisation is an integral part of the securities settlement systems for the UK and Ireland – as "direct-holding" or "transparent" systems.

8. Our fundamental issue is that the Consultation Document does not cater properly for direct-holding/transparent systems. In particular, the failure to distinguish between these two different models gives rise to a number of concerns with the analysis and conclusions set out in the Consultation Document. These concerns include:

- (a) the assumption that all account providers must, by definition, carry on the investment activity of "safekeeping and administration of financial instruments" within Annex I, Section B(1) of the Directive on markets in financial instruments¹ ("**MiFID**") is incorrect, because under a dematerialisation model, the account provider is not a custodian, as it neither safeguards nor administers financial instruments;
- (b) certain risks which the proposed legislation aims to mitigate by imposing obligations upon account providers who "hold" financial instruments do not arise in relation to account providers that do not interpose themselves into the proprietary chain – it is, therefore, not only inappropriate to subject such account providers to obligations that pre-suppose the performance of "securities holding" functions, but it creates legal uncertainty and increased systemic risk, since the manner in which such account providers are intended to satisfy such "holding" obligations and avoid potential liability is unclear; and
- (c) as there will be no account provider that is interposed in the holding chain between the investor and the issuer, there is a material risk that the obligations imposed by the Directive in relation to "ultimate account holders" will fall upon the issuer of securities (as the relevant account provider does not "hold" any securities against which the ultimate account holder may exercise the rights appurtenant to the holding of securities, which are therefore solely exercisable by that account holder against the issuer) – and, as a result, undermine the stated intention that the legislation should not interfere with the issuer's ability to deal exclusively with or upon the instructions of the legal holder of its shares or securities.

9. We also believe that the proposals should not confuse the need: (a) to regulate the business of those account providers who provide the investment service of "safekeeping and administration" as a regular occupation or business; and (b) to provide protections for account holders in relation to their account-held securities. The protections afforded by the proposed Directive should apply to all account providers, irrespective of whether the account provider is regulated under MiFID or other supervisory regime. Thus, it is appropriate for the substantive protections of the proposed Directive (e.g. to protect an account holder against the insolvency of the account provider) to extend to all account providers. The purpose of the Directive should be to support a clearer legal framework for the holding and transfer of account-held securities and, in this way, to enhance the rights of account holders. Its

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Directive 2004/39/EC as amended.

purpose should not be to impose conduct of business requirements on account providers, which is properly the subject of the separate, specific regulatory regime to which an account provider may be subject.

10. In any event, there are a number of cases where it would be wholly disproportionate to impose a requirement for authorisation and day-to-day regulatory supervision on an account provider, including where the account provider enters into the relevant arrangement:
 - (a) as a trustee or personal representative;
 - (b) as agent for the issuer;
 - (c) in the course of a profession or business which does not otherwise consist of investment business; or
 - (d) with another member of the same corporate group or as a participant in a joint enterprise.
11. Conversely, it is of course the case that, even if it is inappropriate to regulate a particular account provider under MiFID (because its business model does not require it to safekeep and administer financial instruments), it might be appropriate to regulate that account provider under another applicable supervisory regime. For example, in its operation of the CREST UK system, Euroclear UK & Ireland Limited ("EUI") is supervised by the UK Financial Services Authority as a "recognised clearing house" and as an approved operator of a "relevant system". The future regulation of entities such as EUI, as operators of important financial market infrastructure, will be dependent upon policy considerations outside the scope of the proposed Securities Law Directive – for example, those considerations that will influence the development, scope and content of the prospective legislation on central securities depositories.

Material differences to the approach taken in other international initiatives

12. In producing its legislative proposals, the Commission is mandated by ECOFIN to bear in mind the benefits of maintaining global compatibility with other jurisdictions. The Geneva Securities Convention represents an internationally recognised body of substantive rules regarding intermediated securities and, therefore, we would suggest any material deviation from its core provisions should be avoided.
13. This policy approach appears to be accepted by the Commission in the body of Question 7 (under section 3.3). The Commission states there that "both the present approach and the Convention are compatible with each other". However, there are in fact a number of key areas in which the Commission's proposals are at variance with the approach adopted by the Geneva Securities Convention, including:
 - (a) the imposition of strict liability upon account providers without due regard to what is practically and economically achievable by them for the benefit of their account holders – this contrasts with the position taken by Article 10(2) of the Convention that it does not require the account provider "to take action that is not within its power" (and, indeed, with the MiFID obligation in relation to sub-contractors to "take all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for

- the holding and safekeeping of" safe custody assets in accordance with Article 17(1) of the MiFID Implementing Directive²);
- (b) the fundamental erosion of freedom of contract for account providers and account holders to agree the content and level of responsibility that is accepted by the account provider for the performance of its functions – this contrasts with the position taken by Article 28 of the Geneva Securities Convention; and
 - (c) the creation of a right in the "ultimate account holder" to receive and exercise rights attached to securities directly against the issuer of the securities or an account provider with whom the ultimate account holder has no contractual or other legal relationship – contrary to the position taken in Article 9(2)(b) of the Geneva Securities Convention.
14. We suggest that any increased costs, exposures or liabilities for account providers which might result from the proposed Securities Law Directive would ultimately be passed on to the account holders. This may take the form of a "direct" increased cost for the services provided by the account provider to its European clients; or, potentially, result in the "indirect" cost of a reduction in the scope of services that financial institutions may be willing to provide to their European clients (if it is considered that such business could be provided more efficiently and effectively from other non-European jurisdictions).
15. While we accept that it is unlikely that the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary (the "**Hague Securities Convention**") will receive recognition in Europe, it is extremely important that the *ex ante* certainty provided by it for the determination of the applicable law to govern proprietary issues affecting intermediated securities should be achieved by the corresponding conflict of law provision contained in the Commission's proposals. Those proposals are set out in section 14 of the Consultation Document.
16. We set out in paragraph 22 below material concerns that we have on the Commission's proposals for a conflict of law rule as they would apply to CREST – as a system for the holding and transfer of securities on records of the issuer or which constitute the primary record of entitlement as against the issuer (a "**direct holding system**"). Insofar as the proposed rule applies to indirect holding arrangements, it should provide far greater clarity on applicable law than is provided by the proposal outlined under section 14 of the Consultation Document. In particular, we consider that any communication provided by the account provider as to the location of the branch which maintains the account (as suggested in section 14, paragraph 2) must be conclusive of the issue of applicable law – as against the account holder or other third parties that may rely on such communication. Regulatory sanctions could be applied to a regulated account provider to prevent any abuse of the conclusive status of this communication. Crucially, however, any failure to accord this status to the communication would mean that the proposed conflict of law principle would provide no, or only minimal, improvement on the present conflict of law position under the laws of the European Union ("**EU**").

² Directive 2006/73/EC

Scope of the proposals

17. The legislation is not intended to "harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities" (see section 1, paragraph 2). We welcome this assurance from the Commission, as we consider that any other approach taken by the legislative initiative would improperly interfere with the company laws of Member States and, potentially, its property laws.
18. However, the Consultation Document refers, in a number of places, to the need to "guarantee" the full exercise of the rights of an account holder (including the "ultimate account holder") – see e.g. paragraph 4 on page 4 ("the full exercise of investor rights must be guaranteed"); and the second indent on page 8 ("EU law addressing the exercise of rights would be in a position to guarantee that the ultimate account holder at least controls the exercise of the rights"). While we support any reasonable and proportionate measures that might facilitate the exercise of investor rights, we consider it essential for the Commission to recognise the need to avoid the imposition of legal responsibilities, whether upon an issuer or an account provider, that would in fact only serve to create legal uncertainty or material inefficiency in the administration of corporate actions. The fact is that the "ultimate account holder" is likely in practice to be a number of steps removed from the issuer or an account provider at a tier closer to the issuer (a "**higher-tier account provider**"). In the absence of any direct contractual or other legal relationship between the issuer/account provider and the ultimate account holder, there may be limited practical means available to the issuer/account provider to determine with any degree of certainty the identity and quantify of the rights of any person other than its immediate legal holder or account holder. Any attempt to do so will, inevitably, require reliance upon account providers (and potentially other third parties) in the chain between the issuer/account provider and the "ultimate account holder". Even if this exercise is carried out with due care (and at no insubstantial cost) there can be no corresponding "guarantee" for the issuer/account provider that the correct result is produced – either as a result of errors made by third parties or legal constraints (e.g. as to confidentiality) which impinge upon the free availability of or accessibility to such information. Any proposed "guarantee" of the ultimate account holder's rights will, therefore, come at a heavy price for issuers and higher-tier account providers. They will incur a potentially uncapped liability to unidentified or unidentifiable third parties who may suffer (or claim to suffer) loss by virtue of the issuer's/account provider's failure to "guarantee" the full exercise of their rights under the Directive. There is also, it seems to us, a considerable concern that (unless tempered) the Commission's proposals will vitiate the issuer's fundamental right to deal exclusively with the legal holder of its securities – contrary to the Commission's stated aim in paragraph 2 of Principle 1.
19. The Consultation Document touches briefly upon issues of territorial scope. Under section 19 there is a discussion on the responsibilities of EU account providers for account holders that are not subject to the rules of the proposed Directive. However, there is a startling absence of any discussion as to how the proposals are intended:
 - (a) to operate where the issuer of the underlying securities is not located in an EU state or where those securities are not otherwise constituted under the laws of an EU state – in particular, the proposals appear to assume that a European account provider will be able to require such an issuer to take certain steps (e.g. to facilitate the exercise of the ultimate account holder's rights in relation to the underlying securities) without due regard to the potential restrictions on

the account provider's rights and powers under the issuer law or against account providers located in jurisdictions outside the EU; and

- (b) to prevent the transmission of systemic risks from jurisdictions outside the EU into the EU by virtue of the proposals for an EU account provider to accept responsibility to its account holders for any legal, regulatory or business failures (including the potential insolvency) of account providers (sub-custodians) located outside the EU.
20. The proposals on "ultimate account holders" and resulting legal uncertainty and increased costs are potentially of sufficient concern that corporate issuers and sovereign issuers of bonds, whether based in the EU or elsewhere, might be driven to issue bonds outside the EU. Particular issues are outlined in paragraphs 38 and 39 below.

Undue interference with arrangements in support of securities settlement systems

21. We welcome the recognition given in the Consultation Document, in certain places, to the primacy of the rules of a securities settlement system. This is particularly important for CREST, as the securities settlement system for both the United Kingdom and Ireland. The CREST system operates under modern legislative codes that were developed by the UK and Irish Governments after extensive consultation with their respective markets, and with particular reference to the bespoke regulatory requirements that are imposed upon operators of "relevant systems" for dematerialised securities constituted under UK and Irish laws. Any failure to support the governing effect of the rules of the CREST systems (which are constituted in legislation as well as by contract) would seriously undermine the robustness of the legal arrangements underpinning those systems, market confidence in them and the efficiency of their operation.
22. There are three key areas where we fear that the Commission's proposals might prejudice the legal model that currently supports the efficient and effective operation of the CREST systems in the UK and Ireland.
- (a) The CREST rules protect an innocent acquirer of CREST securities, unless the acquirer has "actual" notice of a defect in the title of the transferor. It must be made clear, therefore, that the "constructive" ("ought to have known") element of the innocent acquirer principle suggested in section 8 of the Consultation Document does not prevent the laws of a Member State from providing a higher level of protection for the innocent acquirer. This was recognised in the Geneva Securities Convention – see paragraphs 18-14 and 18-15 of the draft Official Commentary to the Convention.
 - (b) The CREST settlement banks, which provide secured credit to participants in the CREST systems, rely on the priority of their system-charges as against subsequent charges over the same charged assets. The settlement bank's charge is effected, in the language of the draft Directive, through a "control agreement". The proposal (under section 9.1) that interests in account-held securities which are acquired by earmarking should have priority over interests acquired in the same account-held securities by means of a control agreement would represent a reversal of the present priority enjoyed by the CREST settlement banks under English and Irish laws. If this proposal is carried through, it may result in an unwillingness on the part of the CREST settlement banks to provide secured credit to participants or to an increase in the cost of

such credit. Either result would potentially prejudice the efficiency of CREST settlement.

- (c) It is important that there should remain absolute clarity as to the applicable law that governs the holding and transfer of securities through the CREST systems – which is English law for English securities, and Irish law for Irish securities. The conflict of laws principle, proposed under section 14 of the Consultation Document, is we understand intended to determine the law applicable to the proprietary effect of transfers of account-held securities. As such, in the context of a direct-holding system such as CREST, the proposed rule will determine the law applicable to govern the effect of a transfer between a transferor and transferee as against third parties such as the issuer of the securities. In this respect, the proposed rule is not consistent with the proprietary analysis that presently applies, and should continue to apply, to CREST securities. The CREST systems are systems for the holding and transfer of securities on records of the issuer or other records which constitute the primary record of entitlement as against the issuer. While EUI (as operator of the CREST systems) provides a system for the holding and transfer of Irish shares and other securities – it does this from its head office in London. The validity and effectiveness of the holding and transfer of Irish shares and other securities through its system (as a system for the primary record of entitlement as against the issuer) is wholly governed by Irish laws. Irish law alone must, therefore, govern those matters identified in paragraph 3 under section 14 as applicable to Irish securities held through CREST. The application of the principles set out in section 14 of the Consultation Document to a direct-holding system, such as CREST, would result in English law governing the holding and transfer of securities constituted under Irish law. This would be a wrong result in principle (as it would subvert Irish company law) and in practice (as it would not reflect the legal arrangements that support the holding and transfer of Irish securities through CREST).

Q2: Would a Principle along the lines set out above [Principle 2] adequately accommodate the functioning of so-called transparent holding systems?

23. Unfortunately, it would not. We welcome the Commission's recognition that its proposals need to address the particular operational and legal issues created by so-called transparent systems (which would include direct-holding systems such as CREST). We understand that the idea behind the Principle in section 2 is that, where a function is not performed by an account provider, legal responsibility under the proposed Directive for the performance of that function can be transferred to the relevant third party. However, the "shared functions" approach adopted under section 2 assumes that, under such models, there will always be a "securities-holding"-related function that is performed by the account provider and, therefore, potentially shared with a third party. The Principle works where the model adopted by a particular account provider requires it to perform both "securities holding" and "account maintenance" functions – some or all of which it might then decide to "share" with a third party who accepts legal responsibility to the account holder. However, the Principle is flawed in its application to models under which the account provider performs one, but not both, of the "securities holding" and "account maintenance" functions. Please see our answer to Question 3 for further explanation and suggestions as to how to address this issue.

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

24. In reality, under certain transparent systems for the holding and transfer of dematerialised securities, the account provider simply does not perform a "securities holding" function – as it does not interpose itself into the proprietary chain between issuer and investor. Its functions are limited to the maintenance, keeping and entering up of the registers or records in response to instructions from the account holder (or other relevant party) – the "account maintenance" function. In essence, an account provider may perform a service under which either or both of "securities holding" and "account maintenance" functions are performed – but it does not follow that both functions will necessarily be performed under the particular business model adopted by an account provider. For example, in CREST, the investor "holds" the relevant domestic securities and has a direct relationship with the issuer – and so there is no account provider that performs any "securities holding" functions where the investor holds securities in its name through CREST. It follows that there is no "securities holding" function for which responsibility can be transferred by EUI (as operator of CREST) to a third party.
25. Our concern is that, as presently drafted, the proposed Directive would impose legal responsibility on an account provider (that does not perform "securities holding" functions) for the performance of those obligations that pre-suppose its performance of a "securities holding" function. Those obligations would include the responsibilities imposed upon account providers under the proposed Directive to "hold" securities in a certain number (under section 4, paragraph 2); to pass on corporate information which it receives in its capacity as a "holder" of securities (under section 16); or to facilitate the exercise of an account holder's rights against the issuer of securities (under section 17).
26. The failure of the proposed Directive expressly to recognise that certain models adopted by account providers do not involve the performance of any "securities holding" functions by them will result in legal uncertainty and systemic risk. This is because it would be unclear how such an account provider is intended to discharge those obligations under the Directive that assume its holding of underlying securities (or interests in securities) – when the account provider does not in fact hold any such securities (or interests). This is a particular concern for such account providers in relation to the potential legal obligations to be imposed in accordance with the Principles set out under sections 4 (paragraph 2), 16 and 17 respectively. This problem is not resolved by the "shared functions" concept, precisely because there is no relevant function that such an account provider can "share" with the third party so as to transfer legal responsibility for them to the third party.
27. In addition, the absence of any recognition of the distinct functions that may be performed under particular business models for the holding and transfer of securities means that the proposals are not responsive to the particular risks created by the different models. As a result, provisions of the proposed Directive might be taken to suggest, incorrectly, that certain insolvency or systemic risks arise if securities are held through a particular business model adopted by an account provider – when, in fact, they do not. For example, if an account provider does not perform "securities holding" functions, the custody risk associated with an intermediated holding of the underlying securities simply does not arise in relation to that account provider. It follows that those provisions of the proposed Directive that aim to minimise custody risk should be disapplied in relation to account providers who operate models under

which custody risk does not arise. This means, for example, that the principles adumbrated under section 10 (protection of account holders in case of insolvency of account holders) and section 13 (attachment by creditors of the account provider) should not be relevant to account providers that do not perform "securities holding" functions.

28. The only robust way to deal with these issues is, in our view, for the Directive expressly to recognise that:
- (a) an account provider may in fact perform either or both of "securities holding" and "account maintenance" functions – but it need not, in fact, perform both; and
 - (b) certain provisions of the Directive only apply where the account provider is responsible to the account holder to perform "securities holding" or, as the case may be, "account maintenance" functions – for example, we consider that the principles outlined under sections 4 (paragraph 2), 10, 13, 16 and 17 should be expressed to apply to an account provider only to the extent that it performs "securities holding" functions.
29. In our response to Question 44, we set out some tentative drafting solutions that might be used to achieve these objectives.

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

30. We do not consider that there are any material difficulties in practice with such links. As part of the normal business and regulatory due diligence of establishing a link or other arrangement for interoperability between two systems, we would expect the respective operators to identify and assess the legal, operational and other systemic risks which might arise in connection with the other system's model for holding and transferring securities. These risks will then be explained to the relevant participants in the respective systems that might wish to hold and transfer securities across any link established between the systems.
31. There is certainly nothing inherently inconsistent with the holding by a participant in System A (a transparent holding system) of securities held in System B (a non-transparent holding system). Indeed, such holding patterns are relatively common in Europe. For example, a member of CREST (a transparent holding system) will hold "CREST Depository Interests" on the Operator register of securities in CREST, which represent interests in securities held for the member's benefit in another (non-transparent holding system) with which CREST has a "link" under its International Settlement Links Service. CREST operates such links with a number of non-transparent holding systems – including, SIS SEGAIntersettle AG, Euroclear Bank SA/NV and the Depository Trust & Clearing Corporation (DTCC).

Q5: Would a Principle along the lines described above [Principle 3] provide Member States with a framework allowing them to adequately define the legal position of account holders?

32. We assume that this question relates to all the relevant elements of the Principle cited at the beginning of this section of the Consultation Document, which are:
- (a) The national law should clarify that securities standing to the credit of a securities account confer upon the account holder at least the following rights:

- (i) the right to exercise and receive the rights attached to the securities if the account holder is the ultimate account holder or if, in any other case, the applicable law confers the right to that account holder;
 - (ii) the right to effect a disposition under one of the harmonised methods (cf. below);
 - (iii) the right to instruct the account provider to arrange for holding the securities with another account provider or otherwise than with an account provider, as far as permitted under the applicable law, the terms of the securities and, to the extent permitted by the national law, the account agreement and the rules of a securities settlement system.
 - (b) The national law should ensure that account holders, which act also in the capacity of account provider for a third person, exercise the rights (ii) and (iii), above in accordance with the instructions of that person (see below).
 - (c) In case of acquisition of a security interest or other limited interest in account-held securities, the national law should be able to restrict the rights (i) to (iii) above.
 - (d) The national law should be allowed to characterise the legal nature of account-held securities as any form of property, equitable interest or other right as far as the characteristics flowing from the legal nature is in accordance with the rights (i) to (iii), above, and the remainder of any legislation.
33. In considering these elements of Principle 3, it is also important to keep in mind the definition of "account provider", "account holder" and "ultimate account holder" provided in the glossary to the Consultation Document:
- (a) 'account provider' is defined to mean a person who:
 - maintains securities accounts for account holders and is authorised in accordance with Article 5 of Directive 2004/39/EC to provide services listed in Annex I Section A indent (9) of Directive 2004/39/EC or is a Central Securities Depository as defined in [...] and, in either case, is acting in that capacity;
 - *[in relation to Principles 3 to 13, if not subject to a national law, in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity.]*

[NB We assume that this indent is intended to be an alternative to the first indent and comment on that basis.]
 - (b) 'account holder' is defined to mean a person for whom an account provider maintains a securities account, whether that person is acting for its own account or for others, including in the capacity of account provider;
 - (c) 'ultimate account holder' is defined to mean an account holder which is not acting in the capacity of account provider for another person.
34. While the four elements of Principle 3 seek to set out a minimum code for each national law, which in many respects would be desirable, it is important to bear in

mind that Article 345 of the Treaty on the Functioning of the European Union ("**TFEU**") provides that "The Treaties shall in no way prejudice the rules in Member States governing the system of property ownership." If powers under the Treaties (e.g. a harmonising Directive) are to be used, then it must be clear that the Principles and their application (as ascertained from relevant definitions), do not in fact cut across any system of property ownership. If it were to do so, then, while individual Member States may sign up to an international convention of similar effect and change their system of property ownership, the Treaties would not provide a basis for requiring such a change.

35. While some Member States will treat intermediation as a matter of property law and see the position of an "ultimate account holder" as that of the owner of a security, others (both common law and civil law) may see the immediate account holder as entitled to exercise the rights of an owner solely as against its account provider, and may characterise those rights as arising from either contract or property law, or as containing elements of both. In so far as the rights arise in contract, they will be relevant at each level in the chain of intermediated relationship only to the account provider and account holder at that level. In particular, the "ultimate account holder" as defined will have no right to assert claims against anyone other than its immediate account provider. That is the case, for example, under English law. English company law does not oblige an issuer to deal with anyone other than an immediate holder of its securities. A member of a company whose shares are admitted to trading on a regulated market who holds shares on behalf of another person may, however, nominate that person to enjoy information rights in relation to the shares. English companies may also provide in their Articles of Association for payments in relation to its securities to be made to another person at the behest of the registered or other immediate holder of its securities.
36. Thus, the person designated as "ultimate account holder" has, under English law, no direct rights as against the issuer to exercise rights attached to the securities held in an account in its name and must give instructions which are passed on up the chain to have any effect on the conduct of the issuer or any intermediate account provider. This is fully consistent with the Geneva Securities Convention, Article 9(2)(b) of which makes it clear that it is for the applicable law and the terms of the securities to determine whether the rights conferred by Article 9(1)(a) on an account holder who is not an intermediary (an "ultimate account holder" in the terminology of the principles of the Consultation Document, although the term is not used in the Geneva Securities Convention) are exercisable only through the chain of intermediaries or directly against the issuer and intermediaries at tiers closer to the issuer. This is also consistent with the Second Advice of the Legal Certainty Group, Recommendation 10. We suggest that the principles be clarified by the inclusion of a provision to the same effect as Article 9(2)(b) of the Geneva Securities Convention. Otherwise, there is a risk that paragraph 1(a) of Principle 3 would potentially require a change in the system of English property ownership, with the resulting concerns that we outline in paragraph 34 above.
37. There is another issue arising from the definition of "account holder" in that it is possible (taking account of the second limb of the definition) that an account holder (particularly an ultimate account holder) could be a person who, under the applicable law, was not intended to be able to exercise the rights of an owner: e.g. a beneficiary of a will before the distribution of property (where, under applicable law, only an executor appointed under the will may exercise ownership rights), a minor or a person suffering mental incapacity (where, under applicable law, only a parent, a guardian,

an official or a court may exercise ownership rights), or one of a large number of joint owners (where, under applicable law, only a trustee, a class representative or the first listed or a limited number of registered owners acting together, to exercise ownership rights). It would be necessary to ensure that the rules adopted did not interfere with these aspects of national law on the exercise of the rights of an owner.

Bondholders meetings and voting

38. As indicated in paragraph 20 above, the "ultimate account holder" proposal raises issues for European bond markets. In particular it is not clear how the proposals to facilitate the exercise of rights flowing from bonds to the ultimate account holder would fit with bondholder meeting provisions. In the bond markets, the legal holder of bonds is the nominee for the common depositary and in practice, the account participants in the clearing system (Euroclear and/or Clearstream) are the ones who can direct voting, receive coupons etc. The question arises as to what would happen if the legal holder of the bonds, as well as any entity or person claiming to be the ultimate account holder, were to attend the same meeting or try and vote in respect of the same bonds. In addition, the process of passing information down a chain and the necessity for account providers to receive instructions in good time to enable them to notify the issuer will always mean that the ultimate account holder has less time than a legal holder of the bonds to make a decision.

Certificate of holding - discharge of payment liability

39. The proposal that the account provider of the ultimate account holder should provide evidence to the ultimate account holder confirming its holding would give rise to potential concerns for the bond markets. Bond issuers currently discharge their payment liability by paying the relevant amount due under the bonds through the clearing systems. It will be important to make clear that the obligation on the account provider to provide the ultimate account holder with a certificate of its holding would not affect the legal question as to whom the issuer is obliged to make payments. In addition, there is a real possibility of fraud, with the potential for a person not the ultimate account holder to claim to be so. There would also need to be stringent measures to prevent forgery of the relevant certificate by persons with no actual interest at all, which could add substantially to cost. See further our answer to Question 6.

Q6: If not, which legal aspects that belong, in your opinion, to an adequate legal position of each account holder could not be realised by the national law under an EU framework as described above? What are the practical problems that might occur in your opinion, if Member States were bound by a framework as described above [Principle 3]? Which are, if applicable, the repercussions on your business model?

40. Please see our answer to Question 5 with regard to the difficulty of harmonising the proposed rights of the "ultimate account holder". We also consider that the issues created by an insistence on special rights for the ultimate account holder in national legal systems which do not recognise such rights, as between the ultimate account holder and the issuer (or another account provider), are not only theoretical. In modern securities arrangements, there are often several layers of intermediation. Intermediation may be the standard also for primary holdings of many securities, including for listed securities which are capable of registration. The smooth working of the system depends upon the account provider at each level knowing clearly from whom it can take valid instructions. It is likely to be wholly unaware of the duties that a person may owe to third parties. It may not know whether that person is acting on

its own account or as an account provider for others or, if it does know it is acting for others, the identity of those others (the disclosure of which may be prohibited by national law e.g. on the basis of a duty of confidentiality). Even if theoretically possible, the whole process would in practice be vastly delayed and made more expensive to a point of difficulty if at each stage the account provider were obliged to ascertain the identity of the ultimate account holder. This would depend upon disclosure. An error or deliberate concealment by the person declared as ultimate account holder would be wholly outside the control of account providers higher up the chain of intermediaries.

41. The business model of all intermediaries would be severely affected if they were obliged to make such inquiries in relation to account holders further down the intermediated chain. Costs would be significant if they were required to insure against liability to an unknown person or persons, when in practice they have to deal with their immediate client (account holder) in accordance with its instructions. The proposed model would substantially increase the risk of multiple claims, whereas when an account provider only has a legal responsibility to act in accordance with the instructions of its immediate account holder this risk does not arise.

Q7: The Geneva Securities Convention³ provides for a global harmonised instrument regarding the substantive law (= content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing with this subject. Most EU Member States and the EU itself have participated in the negotiations of this Convention. Both the present approach and the Convention are compatible with each other.

- **If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?**
- **Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?**

42. For reasons given in paragraph 11 above, we do not share the view that the proposals set out in the Consultation Document are in all material respects compatible with each other. Further, as outlined in our response to Question 5, we doubt that the proposed harmonisation is consistent with the Geneva Securities Convention. Although it would be possible to allow a Member State whose system of law so required to give enhanced rights to an ultimate account holder as against the issuer or an account provider with whom the account holder has no contractual or other existing legal relationship, we do not believe that this could be a basis for harmonisation throughout the EU.
43. On the question of cross-border transactions, we believe that all major financial centres, and certainly London, deal with securities which are held by intermediaries outside the EU and also with securities which are issued by entities outside the EU. Therefore, the interests of the EU financial markets would be better served by adherence to an international Treaty adopted by the countries of other major financial centres (notably the USA, Japan and Hong Kong). As we indicated in paragraph 3 above, we strongly support the mandate provided by the ECOFIN Council to the Commission on 2 December 2008 that any proposed legislative measures should bear "in mind the benefits of maintaining global compatibility with other jurisdictions". Any EU measures should be consistent with other international initiatives – and, at the very least, should not create legal uncertainty or systemic risk for the EU's

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www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm

financial markets or put EU account providers at a material competitive disadvantage in relation to non-EU providers of such services.

Q8: Would a Principle along the lines described above [Principle 4] allow for a framework which effectively avoids that more securities are credited to account holders than had been originally issued by the issuer?

44. In our view, there are two key objectives which must be borne in mind in approaching this Principle. The first is that investors' holdings of securities should be protected to the fullest extent possible against any risk of loss or dilution as a result of fraud or error by intermediaries. The second is that the legal framework should enable the intermediated holding system to deliver swift, efficient and economical settlement of securities transactions; as the Commission is well aware, the marked disparity in cost and efficiency of settlement between the EU and other major securities markets has been one of the most important barriers to the creation of a true single financial market.
45. It follows that the measures adopted to achieve the first objective should at all costs avoid imposing doctrinaire requirements which fail to accommodate the practicalities of swift and efficient settlement. This will require close scrutiny of the techniques adopted by securities settlement systems, in particular the means used to enable simultaneous or ultra-rapid settlement of chains of transactions. These include the use of "circles" processing and of arrangements sometimes referred to as "contractual settlement", by which incoming credits of securities are permitted to be used in ongoing transactions before they are finally settled, provided that the system is able to ensure (for example through internal securities lending arrangements or, if necessary, through the reversal of transactions) that all balances are fully reconciled when each settlement period's processing is completed.
46. We therefore applaud the Commission Services' suggested approach of "seeking the final result rather than detailing the initial methods". We agree that a crude "no-credit-without-debit" rule is for this reason inappropriate. We question, however, whether the detailed formulation of the Principle fully follows this approach. In particular:
 - (a) The formulation of the general principle could be taken to regulate the order in which entries are processed within a securities settlement system to such a degree as to render the use of settlement cycles and "circles" processing impossible. In this respect, it departs from, and in our view compares unfavourably with, the formulation in Article 24(1) of the Geneva Securities Convention.
 - (b) The suggested requirement that conditional credits "must be identifiable as such *in the account* [emphasis added]" implies that an operator's systems must be so set up as not merely to enable it to trace the use of any credits resulting from "contractual settlement" and thereby use the techniques referred to above so as to prevent the incidence of any end-of-settlement imbalances, but that credits attributable to "contractual settlement" should in some manner be "starred" or ear-marked in real time and at all stages of settlement processing. We fear that the imposition of such a requirement would be likely to impose very substantial additional costs (which would, inevitably, fall on investors in the form of higher transaction costs) without any material gain in the protection of their holdings.

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

47. We consider that the formulation in Article 24(1) of the Geneva Securities Convention would be a better basis for the proposed harmonised framework on this point. We think it both possible and desirable for the robustness of the systems (and controls adopted by system operators and other intermediaries to prevent any imbalance arising) to continue to be closely scrutinised by regulators as part of their regulation under MiFID and any other applicable supervisory regime. We think that this would be more conducive to the attainment of the twin objectives of security and efficiency and economy of settlement to which we referred above. As to the second sentence of the question, we would strongly deprecate any suggested rule which required that systems be configured so as to make possible the tracing and invalidation of a specific "excess" credit on the unlikely occurrence of an imbalance which could not be corrected by the techniques referred to above (including internal securities lending, reversal of entries and the buy-in of securities by the intermediary). Such a rule would, we fear, entail a significant increase of complication and cost. It would promote a result which would actually be worse (because it would be unfair and capricious in inflicting the entirety of the resulting loss on a single innocent account holder) than that which would flow from the operation of the backstop rule in Principle 10, which gives sufficient flexibility to treat all account holders in the same position equally.

Q10: Is the Principle relating to the passing on of costs of a buy-in [Principle 4] appropriate? If not, in which way should it be changed and why? What would be the repercussions on your business model?

48. In our view, the proposed Principle is inappropriate, unnecessary and likely to result in serious damage to the efficiency and integrity of EU securities holding and settlement, and also to the choice of services available to investors and to their cost. It would have the effect that each account provider, with very limited exceptions, would be required to underwrite the solvency and operational efficiency of all account providers closer to the issuer in the chain of intermediation. If imposed on the existing pattern of holding, the proposed Principle would therefore create systemic risk. In practice, its probable effect would be to force many intermediaries to withdraw from providing the service, since the contingent liability created by the proposed rule would be one against which they would have no means of protecting themselves and which would call their solvency into question. As a result, competition and investor choice would be substantially reduced. The Consultation Document offers no explanation of why this proposed Principle is regarded as appropriate or as delivering any significant increase in investor protection, let alone one commensurate with the risks and costs to which it would give rise.
49. We accept that there are valid arguments on grounds of investor protection for limiting the extent to which account providers should be able contractually to limit liability for their own default or non-performance and to disclaim responsibility for those of other account providers such as sub-custodians. In our experience, it is not the practice for intermediaries to seek a blanket disclaimer of liability for other account providers, but it is common for them to disclaim or limit liability for losses which are not attributable to some failure on their part to take reasonable care. We think that this issue should

be dealt with as a regulatory matter and that the usual principles of good regulation should be applied in determining in what circumstances and to what extent regulation should override the normal operation of freedom of contract and competitive forces.

Q11: Would a Principle along the lines described above [Principle 5] provide Member States with a framework allowing them to determine legal effectiveness and ineffectiveness to an extent sufficient to safeguard basic domestic legal concepts, like e.g. the transfer of property?

50. Yes, we consider that the Principles outlined under section 5 of the Consultation Document would broadly provide such a framework. However, there are three matters on which we should comment.

Defining the moment of "credit"

51. It must remain a matter for the account agreement and the rules of the securities settlement system to determine what operational or other steps constitute the "credit" of securities to the relevant account. For example, where Irish securities are transferred through CREST, the transferee's account in CREST will be credited for a brief period before the entry of the transferee on the register maintained by or on behalf of the issuer. Under Irish law, the operational credit of the securities to the transferee's account in CREST confers only equitable title to the securities on the transferee; but this does not give the transferee the rights (as against the issuer) of the legal holder. Those rights will only vest in the transferee upon its subsequent entry as holder in the issuer register of securities. For this reason, the CREST rules provide that the relevant securities are not "credited" to the transferee until such time as the relevant "register update request" is received from CREST by the issuer's receiving agent – which will occur, in practice, a short time after the operational credit of the securities to the member's account in CREST.
52. If the proposed Directive were, in any way, to limit the ability of EUI to define the moment of "credit", then the effect of the "operational credit" of Irish securities in a CREST account would be (under the Principle set out in section 3, paragraph 1(a)) to confer rights on the CREST member that it does not in fact have under Irish law. There is a clear and unresolved tension here between Principle 3 and paragraph 2 of Principle 1. The effect of the insertion of the proposed definition of "credit", without qualification with reference to the rules of the securities settlement system, results in an inappropriate interference with the *lex societatis* of a Member State. It would also produce a result that is inconsistent with the principle stated in paragraph 2 of Principle 1 that the "legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities". This principle is further reflected in paragraph 5 of section 5 of the Consultation Document.
53. Similar reasoning would apply to other account providers who might (whether for legal, regulatory or business reasons) wish to define the moment at which the rights of its account holder, as provided by Principle 3 (paragraph 1), arise by reference to a defined set of system procedures other than the simple operational credit of the securities to the account holder. For example, in a delivery-versus-payment (DvP) model it is likely to be desirable to ensure that the "credit" of securities (to the purchaser) does not occur until the corresponding final payment (in cleared funds) occurs in favour of the seller – which may require the "credit" to be defined by reference to the completion of system procedures external to those operated by the account provider of the purchaser. The particular concern here is that the operation

of "straight-through-processing" may, in the interests of settlement efficiency, result in an operational entry in an account provider's records that has the appearance of a credit – but the account provider and the account holder may agree that, as a matter of their legal relationship or otherwise, the relevant rights associated with the "credit" of securities to the account should not arise until additional processing steps have been carried out. This might also, for example, be appropriate in cases where the concept of a "conditional credit" is not recognised or otherwise legally possible under applicable law. These sorts of concerns were, we believe, the reason for the decision taken by the draftsman of the Geneva Securities Convention to omit any definition of "credit" – see paragraphs 11-8, 11-9 and 11-12 of the draft Official Commentary to the Convention. Our preference would be for the Directive specifically to provide that the steps that constitute a "credit" for this purpose should be determined by the rules of the relevant securities settlement system or the account agreement.

Conditional credits

54. We welcome the Commission's recognition of the role that "conditional credits" play in contractual settlement services provided by account providers. However, we believe that any requirement to make the condition "transparent from the account" would be misplaced. This requirement is also expressed in paragraph 3 under section 4 – where it stated that the "condition must be identifiable as such in the account". In our view, any such requirement is likely to result in unnecessary cost for the account provider (in terms of system-build and maintenance), and would not produce any tangible benefit for the account holder or the wider investor community.
55. The Commission suggests that a non-transparent condition in itself may not be an issue "as long as the effects are confined within one system or intermediary". In our experience, conditional credits provided in support of a contractual settlement service should be confined to the account provider. This is because if the account holder were to purport to settle a transaction with a third party against securities which have been conditionally credited to its account with the account provider, the account provider would be required to "lend" the required securities to the account holder to enable it to settle the transaction through the external system. In other words, there should be no on-transfer of a conditional credit to a transferee until the condition is satisfied – either by virtue of a stock loan made by the account provider to the account holder or by virtue of the unconditional and irrevocable receipt of the securities from the account holder's own transferor. As a result, there seems no reason in practice why, as suggested by the Commission, "conditional credits could be passed down a chain of intermediated holdings into a jurisdiction where credits are always legally effective at the moment they occur, creation of uncovered excess-securities might be the result".
56. The potential for this result would be further minimised if, as suggested above, it remained a matter for the account provider (under its account agreement or rules) to determine what cumulative operational or other steps are actually required to constitute the "credit" of securities to the account holder – and before the account holder can exercise the rights conferred on account holders in accordance with Principle 3.
57. In any event, we do not see how the "transparency" of the condition of the credit in the account record itself could prevent or mitigate the risk that uncovered excess-securities might result from the provision of contractual settlement services. Such an operational step adds cost to the provision of such services by account providers, but

it does not add anything to the substantive measures that are or could be taken to prevent such a result (and as we outlined in paragraphs 55 and 56 above).

Other methods of acquisition and disposition

58. Consistent with Article 13 of the Geneva Securities Convention, we suggest that the proposed Directive makes it clear that the methods for acquisition and disposition provided for in Principle 4 do not preclude additional methods under national law. This is because, under English law, a trust or equitable assignment may additionally be used to effect a disposition of an interest in account-held securities. The acceptance of this possibility would appear to be inherent in paragraph 2 under section 9 – but it would benefit from clear expression in the Principles along the lines of Article 13 of the Geneva Securities Convention.

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

59. Please see our response to Question 11 above.

Q13: Would a Principle along the lines described above [Principle 6] provide for a framework allowing effective protection of client securities in case of insolvency of an account provider?

60. We agree with the general principle that transfers of securities which are effected by book entry (or indeed by the other methods described in Principle 4) should not be at risk of being unwound because of a later insolvency event. We also agree that it is of paramount importance that investors and other account holders are not exposed to the risk that their account-held securities fall into the insolvent estate of an account provider and thus become distributed to the account provider's creditors.
61. We do have some concerns that the proposed Principle may not completely meet these objectives.
62. In the first place, we would prefer that it be made clearer as to whose "insolvency proceedings" the Principle is directed. While the commentary indicates that the insolvency of the account provider is the concern, the drafting suggests that other persons' insolvencies may be involved. We suggest that the insolvency provisions of the Geneva Securities Convention be followed more closely. The Convention includes three insolvency articles: Article 14, which is replicated in this principle; Article 21, which deals specifically with the recognition in the insolvency of a relevant intermediary of interests that have become effective under one of the recognised methods; and Article 25(2), which corresponds to Principle 10 of the Consultation Document and confirms that securities allocated to investors' account balances are not property of the intermediary available for distribution among its creditors in its insolvency. Principle 6 appears to conflate the first two and compounds this by suggesting in the commentary that it is about insolvency of the intermediary.
63. We consider it important to make the following completely clear:
- (a) Where an account provider is insolvent, the fact of that insolvency does not alter the finality of any acquisition or disposition effected by means of book entries in the books of that account provider.

- (b) The assets held by an account provider pursuant to Principle 4 are not available for distribution to creditors of the account provider, whether or not there are insolvency proceedings regarding the account provider. In the event of insolvency proceedings regarding the account provider, Principle 10 applies.
- (c) Where an account holder is subject to insolvency proceedings, the fact of that insolvency does not alter the finality of any acquisition or disposition effected by means of book entries in the books of his account provider. However, in the event of any challenge to a disposition based on the voidness, voidability or unenforceability of legal acts detrimental to all the creditors, in which a reversal of the disposition may be ordered, the reversal should take place by **the recipient of the disposition** being ordered to instruct his account provider to carry out a reversal. The account provider should not be required under insolvency laws to make reversals of entries where the account provider is not at fault and is not the beneficiary of the disposition in question.
- (d) The finality rules of the Principle should be consistent with the rules of finality in the Settlement Finality Directive (the "**Settlement Finality Directive**").⁴ Where an account provider is an operator of a designated system under that Directive, we consider that the protections afforded by that Directive should prevail, notwithstanding anything to the contrary effect as a result of the application of the proposed Principle.

64. We do not consider that paragraph 2 of the proposed Principle is sufficiently clear. As indicated above, we consider that sub-paragraph (b) should not apply in the insolvency of the account provider. We believe that sub-paragraph (c) is addressed in Principle 10 and that it would be confusing to reiterate part of Principle 10 here. We do not understand the purpose of sub-paragraph (a), which appears to be a further reiteration of Principle 10, and is too unclear to be desirable.

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

65. We note that there has been considerable publicity surrounding the practice of rehypothecation and the potential impact on account holders' rights. We believe that inadequate record-keeping in the context of rehypothecation has the potential to cause loss to investors in the event of an account provider's insolvency, owing to the inability in such circumstances of the account provider to rectify any errors. However, we consider that the law is already clear as to the duties of account providers in this respect: accordingly, this is primarily a matter of regulatory supervision and we do not think that additional legal rules are needed. Furthermore, even if further regulation were needed, we do not consider that the proposed framework of a Securities Law Directive would be the appropriate instrument for legislation in this area.

Q14(b): Is the list of cases allowing for reversal [Principle 7] complete? Are cases listed which appear to be inappropriate? Are cases missing? What are, if applicable, the repercussions on your business model?

66. The cases listed are not inappropriate, but it would need to be made clear that the proposed Directive does not interfere with the irrevocability of transfer orders, and the finality of settlement, effected through a designated system under the Settlement

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Directive 98/26/EC as amended by Directive 2009/44/EC.

Finality Directive. In any event, we understand that the reversal Principle 7 is intended to be subject to the innocent acquirer Principle 8.

67. However, we do not believe that the list is complete. Further, we consider that, in view of the evolving nature of law and the grounds upon which it may be appropriate (or come to be appropriate) to reverse a credit, some care should be taken in attempting to provide an exhaustive list of events that might justify the reversal of a credit.
68. For example, the reversal of a credit will or might be appropriate:
- (a) in the case of fraud, illegality, duress, undue influence, misrepresentation or any other case where the relevant transaction in respect of which the relevant settlement has occurred is void or voidable under applicable law;
 - (b) if required by any legislative provision (e.g. in support of anti-avoidance measures under applicable insolvency laws); or
 - (c) if otherwise required by a court order.
69. Clearly, if the laws of a Member State are prohibited from requiring the reversal of a credit (e.g. by virtue of the Member State's implementation of the Settlement Finality Directive), then there would be no risk that any enactment or court of that Member State would purport to require any such reversal.
70. We see no material reason why the grounds that might justify the reversal of a credit under Principle 7 should be materially different from the sources of an account provider's obligation to give effect to an instruction under Principle 11. In both cases, the account provider is required or permitted to take action in response to a legitimate authority or legal obligation. Principle 11 provides for a substantially broader range of grounds for action by the account provider than those set out in Principle 7. However, we are uncertain as to the policy justification for this. It is also inconsistent with the approach to this issue adopted in Article 16 of the Geneva Securities Convention. We suggest, therefore, that if the Commission proposes to provide a "closed-list" of reversing events, the definitions of those events should be sufficiently flexible to meet these points by referring (at least and in addition to the currently drafted grounds in Principle 7) to reversal where required or permitted:
- (a) by any judgment, award, order or decision of a court or other judicial or administrative authority of competent jurisdiction;
 - (b) by or under an enactment or any other rule of applicable law; or
 - (c) under any agreement between account holder and account provider.

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

71. As a general principle, we support the contractual freedom of the account provider and the account holder to agree the terms upon which the account holder will hold securities and/or maintain securities accounts. We believe that any concern that the account provider might abuse any dominance in its position in relation to the account holder should properly be left to control through the regulatory regime – for example, as a regulatory matter, a regulated account provider would be required to conduct its

business with integrity, pay due regard to the interests of its customers and treat them fairly.

72. This is an appropriate response, rather than to impose in the proposed Directive restrictions on the ability of the account provider to agree wider rights or powers of reversal. First, it is consistent with the general approach taken in Article 28 of the Geneva Securities Convention that the obligations of an account provider and the manner in which it complies with its obligations should be determined primarily by the account agreement. This would allow the proposed Directive to satisfy the key aim of the ECOFIN Council that its provisions should have due regard to the benefits of maintaining global compatibility with other jurisdictions. Second, a regulatory response to the unfair treatment of account holders by an account provider will be far more sensitive to the range of issues that need to be considered by an account provider in developing its terms to deal with the particular risks or other issues created by its business model – rather than utilising the blunt instrument of a legislative measure to define a closed-list of reversing events. Finally, subject to regulatory considerations, this approach would fundamentally make "account integrity" a competitive issue as between account providers – so that the account holder, if it so wishes, can select an account provider that is willing to reserve only a contractually restricted right of reversal in comparison to other account providers.

Q16: Do you agree with the 'test of innocence' as proposed ('knew or ought to have known') [Principle 8]? Do you know of any practical obstacle that could flow from its application in your jurisdiction? What would be the negative consequences in that case?

73. We support the proposed introduction of a harmonised level of protection for innocent acquirers of intermediated securities. We have the following comments of detail:
- (a) as to the formulation of the test of innocence, we consider that the wording of the corresponding provision of the Geneva Securities Convention (Article 18: "actually knows or ought to know, at the relevant time") is more accurate and that it would be preferable to follow it, both for that reason and for the sake of consistency;
 - (b) we also consider that it would be appropriate to restrict the protection to acquirers who provide value (in other words, to exclude gifts and other gratuitous transactions, as in the Geneva Securities Convention, Article 18(3));
 - (c) we think it important that it be made clear that the phrase "ought to know/to have known" is not to be taken to impose any duty of inquiry or investigation which would not otherwise have existed. Either this should be made clear in the detailed text of the principle or in associated guidance or explanation which would leave Member States free to consider whether it was appropriate to make express provision to that effect in their law;
 - (d) there may be instances in which Member States have chosen, or may in future choose, to confer protection by reference to a more generous test than the "knows or ought to know" formula, for example by protecting a purchaser unless he *actually* knew of the relevant defect. The UK, for example, currently confers protection substantially to this effect on purchasers of securities through the CREST settlement system. It should be made clear in this connexion whether the proposed Directive is intended to be a minimum or maximum harmonisation measure. If it is to be the latter, we think that there

should be some flexibility for Member States to confer greater protection at least in defined cases such as that mentioned above.

Q17: Will a Principle along the lines set out above [Principle 9], under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not 'visible' in the relevant securities account? If not, please explain why.

74. No, we strongly suggest that the Directive provide for priority rules on the basis that:
- (a) priority will be governed by the chronological order in which security interests of the same type are created over the same account-held securities, whether the security interest is perfected by earmarking or a control agreement;
 - (b) no distinction should be drawn for priority purposes between earmarking and a control agreement, provided that the account provider is a party to the control agreement or has been given notice of its existence;
 - (c) the parties should be free by contract to vary or supplement these priority principles as amongst themselves but without affecting the rights of third parties.
75. We see no reason why security interests perfected by means of a control agreement should be given an inferior ranking to those perfected by earmarking. We note that there is no such mandatory distinction made in Articles 19 and 20 of the Geneva Securities Convention. The Consultation Document refers to “transparency” and implies that interests perfected by earmarking should have priority over interests perfected under a control agreement on the basis that they are more “transparent”. If this is the argument, it is one which in our view lacks any substance or practical reality. The concept of “transparency” in relation to records which are neither maintained in physical form nor open to investigation by interested third parties is wholly artificial. We assume that the underlying concern is that, where an interested third party is contemplating advancing money or credit to an account holder on the security of an interest in intermediated securities of an account holder granted by one of the methods referred to in principle 4.1(5), that third party should have a means of satisfying itself, when taking such an interest, that there is no existing prior interest. We agree with this concern; but the only way in which the third party can so satisfy itself is by enquiring of the relevant account provider. Such an enquiry will reveal such a prior interest whether it has been perfected by earmarking or by a control agreement (since an agreement of which the account provider is unaware will not be a “control agreement” as defined). “Transparency” therefore provides no justification for discriminating against control agreements in the manner proposed. Moreover, if this proposed rule were introduced into English Law, it would conflict with existing English priority rules and also give rise to serious problems for secured creditors.
76. English law and other common law systems draw a distinction between a legal interest and an equitable interest. Generally, unless it would be inequitable, a person with a legal interest will take priority over a person with an equitable interest. So, a person who acquires legal title to an asset for value without notice of an earlier equitable interest will take free of it. The taking of a legal mortgage over securities involves a transfer of those securities to an account in the name of the mortgagee or its nominee. Hence it appears that the use of earmarking or a control agreement

would be relevant only when taking an equitable mortgage or charge over account held securities.

77. The general rule is that, in the case of successive equitable interests, the first in time will take priority. This is subject to two exceptions which may be relevant here. First, where the mortgaged property consists of intangible property, such as the right to receive money from a third party, the first person to give notice of his interest to the obligor will take priority, regardless of when his interest is actually created.
78. Secondly, priority may depend on whether an equitable interest is created by way of fixed or floating charge. A floating charge permits the charging company to deal with its assets in the ordinary course of its business unless and until the floating charge crystallises and becomes a fixed charge. This authority to deal includes the power to sell and, unless otherwise agreed, the power to create security interests in favour of third parties. The ability of a company to create security interests in favour of other creditors is often prohibited or restricted by a negative pledge contained in the floating charge. A person taking a subsequent charge will rank behind the floating charge if (i) the floating charge has already crystallised or (ii) the floating charge contains a negative pledge and, in each case, that person has actual or constructive notice of that fact.
79. It is common practice in the UK to take a floating charge over a portfolio of securities where the charging company wishes to be free to buy and sell securities within the portfolio. Even if the charge is described as a fixed charge, it may be re-characterised by an English court as a floating charge if the charge holder does not exercise sufficient control over the charged property to sustain the fixed nature of the charge. In either case the charge holder will commonly rely on a negative pledge.
80. Even if the negative pledge amounts to or supports a "control agreement" for the purposes of the proposed Directive, the charge holder could still lose priority and rank behind the holder of a subsequent charge over the same securities where those securities had been earmarked in the latter's favour. For this reason we suggest that the general rule be that security interests of the same type should rank in order of date of creation, whether perfected by earmarking or a control agreement. Alternatively, if a subsequent earmarking arrangement is to be given general priority over a control agreement, that priority should be lost if it is taken with knowledge that it breaches a negative pledge contained in an earlier charge perfected by way of a control agreement. A similar proviso is included in Article 20(2) of the Geneva Securities Convention. For instance, if the proposal in section 9.1, paragraph 1(c), is retained, a subsequently created charge perfected by earmarking should not be given priority over a charge perfected by a control agreement where the holder of the subsequent charge knows or ought to know that it was breaching a negative pledge under the terms of an existing charge in doing so.
81. The expression "earmarking" is described in the glossary to the Consultation Document to mean "an entry in a securities account made in favour of a person". This seems too narrow. We suggest that it should expressly cover the situation where securities are transferred into an account charged or pledged in favour of a collateral-taker or held in its name or on its behalf. In addition, the above existing wording suggests that the entry must appear in the designation of the account. If this is intended, it will be necessary to check that computer-based systems used by banks, financial institutions and other intermediaries across the EU are capable of designating accounts in the desired way and, if so, to do so without costly systems changes or upgrades. We doubt whether this is universally the case.

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

82. Where a charge is taken over securities held in an account with a third party such as a custodian, it is normal practice under English law for notice of the charge to be given to the third party. If a fixed charge is being taken, this will typically provide that no securities may be withdrawn from the account without the prior consent of the charge holder and that the charge holder may give instructions to the custodian in relation to the charged securities. The custodian will be asked to sign a written acknowledgement, confirming receipt of the notice, agreeing to waive its own rights of lien or set off against the account and agreeing to act in accordance with the terms of the notice. If this is done at the outset, the charge holder is protected and obtains priority. The combined effect of the notice and acknowledgement would be to constitute a control agreement. Where securities are held in a blocked account controlled by the charge holder, it is not easy in practice for them to be transferred to another account earmarked in favour of another creditor except with the consent of the charge holder. However, where the securities are subject only to a floating charge, this would be much easier to do and so exposes a floating charge holder to the risk of loss of priority – and this is why the "negative pledge" approach outlined in our response to Question 17 is used.

Q19: Would there be negative practical consequences for your business model flowing from a Principle along the lines set out above [Principle 9]? If yes, please specify.

83. We consider that the proposal in section 9.1, paragraph 1(c), of the Consultation Document could result in serious legal uncertainty for CREST settlement banks. CREST is the securities settlement system for dematerialised UK, Irish and international equities, public sector securities and money market instruments. CREST is operated by EUI. EUI is itself a recognised clearing house under the UK Financial Services and Markets Act 2000; an operator of a "relevant system" under the UK Uncertificated Securities Regulations 2001 (and equivalent regulations in Ireland); and operator of "designated systems" under the Settlement Finality Directive.

84. Transactions in sterling and euros settle in CREST on a Delivery-versus-Payment (DvP) basis. Payments of approximately £1 trillion⁵ are made each day through the system. Such payments are only possible as a result of the credit and liquidity facilities which are provided to CREST participants by CREST settlement banks (consisting of leading UK, European and US financial institutions). Each CREST settlement bank will incur an exposure to its CREST participant-customer in relation to CREST payments that the bank makes for the account of the participant. The exposure arises because, under the inter-bank payment arrangements that support settlement, a settlement bank incurs an obligation as principal to effect payment at the moment of CREST settlement (for the account of its customer), but it will not seek reimbursement from the CREST participant until the end of the settlement day or at a later time. This obligation of reimbursement is usually secured by a system-charge

⁵ The daily average value of securities moving through the CREST system in November 2010 was in the order of £1,453 billion, while the daily average value of cash moving through CREST was in the order of £924 billion, including self-collateralising repo transactions: see the market performance statistics for Euroclear UK and Ireland on www.euroclear.com.

taken in the form of a floating charge by the CREST settlement bank over the participant-customer's (or its nominee's) CREST securities.

85. The form of floating charge used by CREST settlement banks contains a negative pledge. A fast track enforcement procedure has also been established so that, if a system-charge becomes enforceable, the relevant settlement bank would be able to give properly authenticated dematerialised instructions to EUI, as operator of the CREST system, for the transfer of the charged securities. The method used to achieve this is to appoint a settlement bank as the "sponsor" of the relevant CREST member so that the settlement bank can, if the need arises, intervene and give such electronic instructions direct to EUI, as contemplated in Chapter 6, Section 7, of the CREST Reference Manual⁶. These procedures were recently used successfully and efficiently by the CREST settlement bank of Lehman Brothers International (Europe) after its entry into administration in September 2008. These arrangements are likely to amount to a "control agreement" for the purposes of the Directive. However, under the above proposal, CREST settlement banks would run the risk that they could lose priority to a creditor taking a subsequent charge perfected by earmarking.

Q20: Would a Principle along the lines described above [Principle 10] pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?

86. We assume that this question relates to both elements of Principle 10 which are that:
- (a) The national law should ensure that, in the event of insolvency of the account provider, securities and account-held securities held by the account provider for its account holders should be unavailable for distribution among or realisation for the benefit of creditors of the account provider.
 - (b) The national law applicable in the insolvency of an account provider should provide for a mechanism governing the allocation of the shortfall in the event of an insufficient number of securities or account-held securities in the sense of Principle 4, paragraph 2 being held by an insolvent account provider.
87. We agree with the principle outlined in paragraph 86 (a) above and would hope that it was already largely reflected in the law of most Member States. In English law, property which is held in segregated accounts for clients of a failed account provider (or physically deposited and segregated where it has a recognised corporeal form (e.g. an old fashioned bearer bond with interest coupons)) cannot be distributed, except to persons who are account holders or persons claiming through those account holders (e.g. chargees, collateral takers, persons entitled under the law of inheritance). Where assets have not been effectively segregated in a general or specific client account, despite being received on a basis where they should have been so segregated, then, on an insolvency, those assets may, to the extent retained by the insolvent entity, fall into the assets available for the general body of creditors, unless they can be identified under laws on tracing of misappropriated property and restored to the segregated accounts or individual client.
88. There is no principle of English law that, without more, automatically prefers account holders over the general body of creditors where there is a shortfall. In an extreme case (e.g. where active fraud is involved), there may not be sufficient assets in the company as a whole to refund all account holders. We refer to Article 25 of the

⁶ Available at www.crestco.co.uk (legal documentation appears under "resources").

Geneva Securities Convention which, unlike the first limb of Principle 10, makes it clear that the allocation of securities to account holders' account balances may be effected either by a rule of law or, "to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary" (which would cover mandatory segregation under the current UK arrangements) .

89. As to the principle outlined in paragraph 86 (b) above, where there is a shortfall, there should be a mechanism in national law addressing the distribution of securities segregated by the account provider in a pool covering the assets of more than one client. This should not extend to pooling of assets where the account provider has placed them in a separate account with a custodian (or another body providing accounts to it) in the name of one account holder only. That account should simply be made available to the named account holder. We note that Article 26(2) of the Geneva Securities Convention expressly provides to that effect.
90. Where there are segregated assets which are held in a pool for more than one client and there is a shortfall, we suggest that they are distributed on a pro rata basis by reference to the full entitlement, rather than on a strict application of tracing rules which are complex and expensive to apply and produce winners and losers among account holders. The UK is contemplating such a rule in relation to its introduction of a special resolution regime for investment banks: see regulation 12(3) of the draft Investment Bank Special Administration Regulations 2011⁷. This approach is consistent with the Geneva Securities Convention, Article 26(2)(b).

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

91. In the light of our answer to Question 1, we do not believe that the Principles, if drawn to reflect the points made above, would call for additional mechanisms.

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

92. While we have a preference for the pro rata principle, we believe that the process adopted does impinge on national law of personal property and therefore it should be left to national laws to provide the precise solution which they consider appropriate.

Q23: Would a Principle along the lines described above [Principle 11] provide for a framework allowing the national law to effectively apply restrictions on whose instructions to follow for purposes of investor protection, notably in connection with the envisaged Principle contained under section 4 (Paragraph 2)? If not, please explain why.

93. Yes, we believe that a Principle along these lines would provide a suitable framework.
94. However, we consider that it would be important to clarify that paragraph 2(a) under Principle 11 is intended to permit the account provider, if so agreed, to rely without further enquiry on an instruction, which is purportedly sent by or on behalf of the account holder, in circumstances specified by the account agreement. For example, the account agreement may specify certain authentication procedures that should be used and verified before the account provider is entitled to assume that the instruction has been sent by or on behalf of the account holder. If such procedures are satisfied,

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See www.legislation.gov.uk/ukdsi/2011/9780111505588/contents

the account provider should be able to act without liability, even if it is subsequently discovered that the instruction was not genuine or was not correct or was unauthorised.

95. While we believe that this sort of authentication procedure or other reasonable reliance on a purported instruction is intended to be covered by paragraph 2(a), the Commission's reference to third party mandates in its commentary under section 11.1 might suggest a narrower scope for this exception to the Principle in paragraph 1. The operational efficiency and effectiveness of an account provider's execution of instructions would be materially adversely affected if the proposed Directive did not allow it to act upon instructions which it reasonably considers (in accordance with such authentication procedures it has put in place) have been sent by or under the authority of the account holder.

Q24: Would a Principle along the lines described above [Principle 12] provide Member States with a framework allowing them, in combination with the envisaged Principle on shared functions [Principle 2], to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.

96. We consider that a Principle along the lines above would make it possible to reflect operational practice regarding the attachment of securities in England and Wales (or orders having a like effect).

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

97. We have not identified instances where clients of our member firms have actually faced, or sought to instigate, attempts to attach securities, or to secure injunctions or other orders which could have the effect of attaching securities, at a level other than that of the intermediary maintaining the securities account of the relevant debtor or defendant. However, member firms have had occasion to advise clients in circumstances on the possibility of such an attempt; and we consider that, although the risk of such an attempt being successful is small, the damage that would be caused if it were successful even for a short time and the residual uncertainty arising from such a possibility are serious enough to make a provision along the lines suggested highly desirable.

Q26: Would the proposed framework [Principle 13] for protecting client accounts be sufficient? Should the presumption that accounts opened by an account provider with another intermediary generally contain client securities become a general rule? If not, please explain why.

98. We agree that creditors of an account provider should not be able to attach the securities which the account provider holds pursuant to Principle 4 for the benefit of its account holders.
99. We do not agree that there should be such a general presumption as is described. In some jurisdictions, where there has not to date been effective segregation between "client" and "proprietary" assets, such a presumption makes good sense. But in other countries, there are such structures. To introduce a general presumption would create legal uncertainty over the effectiveness of existing mechanisms, which may not be explicitly documented, but which would nevertheless be legally robust as things stand. We think it is vitally important to maintain national discretion in this regard.

Q27: Would a Principle along the lines described above [Principle 14] allow for a consistent conflict of laws regime? If not: Which part of the proposal causes practical difficulties that could be addressed better?

100. In our view, the Hague Securities Convention represents the best solution to the conflict of laws issues created by account held securities, both on its merits and because, if ratified by the EU and Member States, it would offer the real prospect of a globally agreed solution and thereby remove a very significant continuing source of uncertainty and legal risk. We remain disappointed about the difficulties that have arisen within the EU in relation to ratification and are concerned about the continuing damage which those difficulties inflict on the international credibility of the EU and the Member States, bearing in mind that the EU and the then Member States were closely involved in the negotiation of the Hague Securities Convention and unanimously supported the final text at the time. We therefore urge the Commission to abide by its original policy of pressing for ratification of the Hague Securities Convention.
101. If, notwithstanding these points, considerations of what is practicable point, at least for the present, towards a development of the tests ("location of account" or "location of account maintenance") used in the Settlement Finality Directive, the Directive on financial collateral arrangements (the "**Collateral Directive**") and the Directive on the reorganisation and winding up of credit institutions (the "**Credit Institutions Winding Up Directive**"), a key objective will be to devise a test that is coherent and provides ex ante certainty. It will also be important, of course, that those other Directives be amended to ensure that they remain consistent with the solution ultimately adopted in the Securities Law Directive. The inter-action with the EC Regulation on insolvency proceedings (No. 1346/2000) and the EC Regulation on the law applicable to contractual obligations (Rome 1) (593/2008) will also need to be considered. In addition, it should be made clear in the Securities Law Directive that the proposed rule is not intended to determine the law applicable to the contractual rights and obligations as between a transferor and transferee – with a view, in particular, to avoid any interference with personal rights and obligations in relation to ex and cum dividend rights.
102. In our view, the proposed Principle 14 fails to achieve this objective in two material respects. It would need to be amended accordingly to deal with these issues.

Lack of required ex ante certainty

103. In our view, the proposed Principle (as currently drafted) would not materially increase the clarity and certainty of the existing *lex situs* tests. This would be a grave failure to resolve an issue that has consistently concerned participants in the European markets; and which cries out for a robust and practical conflict of law rule. In this respect, we would question the Commission's assertion that it is rare for there to be any divergence as to where account-held securities are "located". That is certainly not our experience as legal practitioners. Further, the likely values that are dependent upon the correct determination of the law governing the sorts of issues identified in paragraph 3 of Principle 14 means that it is imperative for legal advisers to be able to identify that law with complete certainty.
104. While the proposed "relationship" test might go some way to guide an interested party as to the "location" of where the account is maintained, it does not go nearly far enough. This is because it requires a factual investigation, and subsequent judgment, as to matters that are unlikely to be readily available, or apparent or capable of

evaluation by the interested party. This is particularly so where the interested party is a third party without any day-to-day knowledge of how the relationship between the account provider and the account holder is conducted in practice – for example, a creditor of the account holder who wishes to accept the account-held securities by way of collateral.

105. Conversely, these matters should be readily available, apparent and capable of evaluation by the account provider. In this respect, we welcome the proposal in section 14.1, paragraph 2, of the Consultation Document that the account provider should communicate with the account holder whether the head office or an identified branch handles the relationship with the account holder. However, as the account holder or an interested third party has no real means of verifying whether this communication is correct, it may suffer material loss if this subsequently proves to be incorrect. We therefore urge the Commission to provide that any such communication should be conclusive as against and for the benefit of the account holder and any third party who relies upon the communication.
106. If the Commission is concerned that this may somehow result in account providers fraudulently, wilfully or negligently "re-locating" their account relationships in a manner which does not reasonably accord with the proposed fact-based tests, then we suggest that this would be more appropriately and effectively resolved through the imposition of regulatory sanctions upon the account provider. This would ensure that the consequences of any error, in the determination of the location of where the account is maintained, are visited solely upon the person who is best placed to control that risk. It should not affect the ability of third parties to rely with certainty upon the determination of the law applicable to the issues identified in section 14.1, paragraph 3, of the Consultation Document. Such a solution would enhance the robustness of European law in this area, would bolster market confidence in the solution and thus improve the efficiency and effectiveness of our financial markets. These objectives would be balanced against the risk of fraud, wilful default or negligence on the part of the account provider through the regulatory controls to which the account provider can be made subject (through separate supervisory regimes established under MiFID or otherwise).

Direct-holding/transparent systems

107. The solution proposed under section 14 of the Consultation Document does not work for certain direct-holding or transparent systems for the holding and transfer of securities on the records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer – such as the CREST systems for UK and Irish securities. EUI, as operator of the CREST systems, has its head office in London. It has no branch or other establishment in Ireland. CREST sends electronic messages from its core processor to the issuer's registers located in Ireland – and those registers alone constitute the legal title of the holder to the Irish securities. EUI would be considered, under the tests proposed under section 14, to handle its relationship with the CREST members (whether in relation to their UK or Irish securities) from its head office. As Principle 14 deals with the proprietary effects of a transfer between two parties, it would (without qualification) determine the law applicable to govern the effect of the transfer as against third parties – including the issuer of the securities. This would result, under Principle 14, in English law governing those matters set out in paragraph 3 in relation to Irish securities that are held and transferred by means of the CREST system.

108. However, such a result would be wrong in principle. It would conflict with the accepted and clear conflict of law solution in relation to directly held shares and securities. This looks to the place of incorporation of the issuer, the place of the location of its register or the law which governs the effectiveness and validity of transfer orders that effect a disposition of title to the relevant shares or other securities. In all these cases, Irish law governs in relation to Irish shares or other Irish securities held through CREST. It is also the case that, to the extent the CREST system operates for the execution of transfer orders in relation to Irish shares or other Irish securities, it is designated for the purposes of the Settlement Finality Directive in Ireland (and not in the UK). In other words, EUI's formal arrangements for the execution of transfer orders in relation to Irish securities are governed by Irish law alone.
109. Similar issues would arise in relation to the holding and transfer of Scottish or Northern Irish securities in CREST, where Scots and Northern Irish laws respectively govern proprietary issues in relation to such securities.
110. This is a clear and coherent conflict of law solution for non-English securities held in CREST. It reflects the practical reality, for example, that Irish company law alone can and should govern the effectiveness and validity of dematerialised instructions to transfer title to shares constituted under Irish law; and where the legal title to such shares is recorded on registers located in Ireland. Unless direct-holding/transparent systems, such as CREST, are excluded from the scope of proposed Principle 14, the proposal will create legal uncertainty and undermine market confidence in the UK and Irish securities settlement systems.
111. This issue was recognised in Article 1(5) of the Hague Securities Convention. We suggest that a similar exclusion from Principle 14 would be required. It might be achieved by the inclusion of a new paragraph along the following lines:

"This Article does not apply to account-held securities credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such account-held securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer."

Q28: Would the mechanism of communicating to the client [Principle 14], whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to ex ante clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?

112. Please see our response to Question 27.

Q29: The Hague Securities Convention⁸ provides for a global harmonised instrument regarding the conflict of law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed Principle 14 differs from the Convention as regards the basic legal mechanism for the identification of the applicable law. However, the scope of Principle 14 is the same than the scope of the Convention: property law, collateral, effectiveness, priority. Do you agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, please explain why.

⁸ www.hcch.net/index_en.php?act=conventions.text&cid=72

113. For the reasons explored in greater detail in our response to Question 27, we consider that as presently drafted proposed Principle 14 would *not* materially facilitate the resolution of conflicts of law issues. However, if the proposal were modified in the manner we suggest above, we believe that it would represent a significant improvement in the current European conflict of law rule and would enhance market confidence in its robustness, clarity and coherence.
114. In the absence of a harmonised global approach, there remains a real risk that non-EU jurisdictions will apply a different and incompatible rule, with the result that proceedings in different courts will apply different laws to the same issue. In our view, it therefore remains highly desirable to resolve the current difficulties surrounding the Hague Securities Convention.

Q30: Would a general non-discrimination rule along the lines set out above [Principle 15] be useful? Have you encountered problems regarding the cross-border exercise of rights attached to securities?

115. We think that a general non-discrimination rule along the lines set out above will be useful so far as it goes, but it is not clear to us why the Commission has included the principle only at this high level of generality and has not focused on the most common specific manifestations of discrimination in practice, as do the provisions of the Shareholders' Rights Directive referred to an Article 29(2) of the Geneva Securities Convention. In particular, we are aware of instances where the absence of any ability to appoint multiple proxies or to exercise votes or other rights attached to securities in different ways constitutes a practical obstacle to the effective and convenient holding of securities through intermediaries.
116. The question arises whether, if the Directive were to require the imposition of a general rule in relation to debt securities in terms corresponding to the rules of the Shareholders' Rights Directive referred to above (broadly, multiple proxies and split voting must be permitted), what should be done about securities already in issue. A rule overriding the terms of issue for future meetings would appear not strictly to contravene the principle of non-retrospectivity, but might be perceived by issuers as doing so, particularly if it had cost implications. Having said that, it would be necessary to consider whether there are many securities outstanding whose terms would contravene the basic rule.

Q31: If applicable, would a Principle along these lines [Principle 15] have (positive or negative) repercussions on your business model? Please specify.

117. Please see the answer to Question 30 above.

Q32: Is the duty to pass on information adequately [Principle 16] kept to the necessary minimum? Is it sufficient?: If applicable, would there be any (positive or negative) repercussion of such a Principle on your business model? Please specify.

118. We have a number of concerns about proposed Principles 16 and 17. Most of the concerns relate to the operational feasibility of the proposals. Although we have significant doubts about the practicality of what is proposed, we think it better to leave it to the providers of accounts to comment on the operational and technical aspects of the proposal. Accordingly our comments are directed to the legal issues raised by the proposed Principle.

119. First, we note that the absence of geographical limitation in the Principles will require the proposed flow of information to include cases where the issuer, the account provider, and the ultimate investor might be outside the EU. There may be a significant risk of violation of foreign law in such cases where an account provider is obliged to take steps mandated by the proposed Principle.
120. Secondly, the liability associated with the obligations imposed under the proposed Principle needs to be allocated. As presently formulated, the Principle does not specify which system of national law applies. This means that an account provider may be subject to the laws of several Member States, with differing standards, in complying with the Principle. This may give rise to multiple jeopardy for a single failing.
121. Thirdly, the proposal does not set out who is to bear the cost of passing on the information - the account provider, the ultimate account holder or the issuer (who has no say about the way in which an investor chooses to hold their investment).

Q33: How do you see the role of market-led standardisation regarding the passing on of information? What are your views on a regulatory mechanism for streamlining standardisation procedures [Principle 16]?

122. We have no legal comment on these proposals. We can see potential benefits in there being a market standard. Where an issuer is required to provide information on its website, there could be merit in the information being passed on by passing on a link to the website.

Q34: If you are an investor, do you think that a Principle along the lines described [Principle 17] would make easier any cross-border exercise of rights attached to securities, provided that technical standardisation progresses simultaneously? If not, please explain why.

123. We also repeat our observations under Question 32 in relation to the geographical scope of the proposals and other applicable legislation. It does not seem realistic or practical, and it may be unlawful, to assure that a non-EU ultimate account holder is provided with these rights, and likewise it may be unlawful and/or contrary to the terms of issue for an issuer or account provider to provide or recognise these rights to or in favour of certain ultimate account holders.

Q35: If you are an account provider, would you tend towards the opinion that your clients can exercise the rights attached to their cross-border holdings as efficiently as their domestic holdings? What would be the technical difficulties you would face in implementing mechanisms allowing for the fulfilment of the duties outlined above? What would be the cost involved?

124. We repeat our observations under Question 32 in relation to our role as lawyers rather than operations experts. We also repeat our comments at Question 34 and our comments at paragraphs 38 and 39 above.

Q36: If you are account holder, have you encountered differing prices for the domestic and the cross-border exercise of rights attached to securities [Principle 18]? If yes, please specify.

125. We are not able to comment on this question.

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

126. While we are not account holders or providers in a professional capacity, we advise bodies performing both these roles. There may be good reasons for differing prices according to the place where the securities are issued or held, whether within or without the EU. These include the nature of the securities and the way that they are held for the purpose of the records of the issuer (in the case of registered issues) or a body such as Euroclear Bank (in the case of unregistered issues); these may mean that different costs arise in connection with the collection of dividends or interest payments which may vary according to the jurisdiction or type of security concerned. Also securities issued in a country other than that of the relevant account provider may be more likely to go through a larger number of levels of intermediation, which is likely to increase costs. Finally, there will be differences in the cost structure and tax levels, both general and specific to dealings in securities between different countries and different types of intermediary. These are unlikely to produce uniform charges.
127. We see no reason why charges should not vary for objective reasons, some of which are likely to relate to differences in jurisdiction. While we would oppose the blanket imposition of higher charges for cross border transactions, we see no reason why objectively justifiable differences should not be permissible. We also believe some averaging should be allowed in order to ensure that tariffs are clear to customers.
128. We believe that the regulation of charges is in any event a regulatory matter and not suitable for inclusion in the proposed legislation.

Q38: Have you encountered difficulties in using non-EU linkages as regards the exercise of rights attached to securities [Principle 19]? If yes, please specify. If not, please explain why.

129. As we have outlined in paragraph 19 above, Principle 19 appears to be concerned with the situation where the issuer of the securities is located in the EU or has otherwise constituted its securities under the laws of a Member State; and there is an interposing EU account provider between the issuer and a non-EU account holder (which itself maintains account-held securities for others). There is, however, a complete absence of any provisions in the proposals to deal with the situation where the underlying issuer is *not* located in the EU or the securities are otherwise constituted under the law of a non-EU State. Material practical and legal issues would be created by any attempt to impose upon an EU account provider, in relation to its account holder or (worse) an ultimate account holder, the proposed obligations in the Directive (e.g. those in Principles 16 and 17) in respect of non-EU securities. These proposals may conflict with the laws under which the issuer's security is constituted or the terms of issue of the security; and it may simply not be practicable lawfully for an EU account provider to "ensure" the exercise of the account holder's rights as against such an issuer in the manner contemplated by those (or other) Principles set out in the Consultation Document.
130. We advise clients, including operators of securities settlement systems and custodians, on their "links" and other arrangements with non-EU providers of services supporting the holding and transfer of securities on a cross-border basis. Where the issuer is located in a Member State or has otherwise constituted its securities under the law of a Member State, we do not consider that in practice there has been any material difficulty in ensuring that the (ultimate) account holder has been able to

exercise the rights attached to the securities. The EU account providers can generally be expected, under the terms of their arrangements with the account holders, to exercise the rights they hold as "legal holder" in accordance with the instructions received from the account holder. If the account holder is itself an account provider (whether within or outside the EU), it will owe its own contractual or other legal responsibilities to its account holder in relation to the exercise of those rights.

131. Equally, where an EU account provider holds non-EU securities through a non-EU central securities depository or sub-custodian, that EU account provider will be under its own contractual or other legal responsibilities to its clients in relation to the manner in which it must exercise those rights. Indeed, for account providers who "safekeep and administer" securities as a regular occupation or business activity, the terms upon which they appoint such a non-EU sub-custodian will be shaped by the overriding regulatory obligation to "take all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of" safe custody assets in accordance with Article 17(1) of the MiFID Implementing Directive. This requires such account providers to have appropriate terms with the non-EU sub-custodian dealing with: (a) the procedures and authorities for the passing of instructions to or by the EU account provider; and (b) the procedures for claiming and receiving dividends, interest payments and other entitlements accruing to their own account holders.

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

132. The fundamental problem for an EU account provider who has a non-EU account holder (which is itself an account provider) is that the EU provider has no contractual or other direct legal relationship with the non-EU provider's own clients. Those clients, for their own reasons, have decided to contract for the provision of custody or similar services with a non-EU account provider. It is not readily open to an EU account provider to require its own account holder to "guarantee" the rights of the non-EU account holder's own clients. Indeed, there are likely to be a multitude of legal, regulatory and business restrictions on the practical ability of the EU account provider to interfere with the relationship between the non-EU provider and its own clients so as to require the Directive protections for account holders to be "guaranteed" by the non-EU provider. Even if such contractual rights could be procured by the EU account provider for the benefit of the underlying client, it would be extremely difficult, in practice, to give any degree of effective monitoring of those rights for the benefit of the underlying client (bearing in mind the EU account provider has no contractual or other legal relationship with the non-EU provider's client). The result will either be extensive non-compliance by EU account providers with this requirement of EU law, or a material increase in the costs for clients to use their services to reflect the substantial due diligence and monitoring exercise that an EU account provider would be required to undertake in relation to each of its non-EU account holders who themselves maintain account-held securities for others.
133. Against this background, we are struggling to see what "reasonable and appropriate" measures might be taken by the EU account provider, as against its account holder, to facilitate the exercise of the Directive rights by the non-EU provider's own clients in the manner contemplated by Principle 19. Further, we question on what legitimate basis European institutions should seek to impose (in effect) extra-territorial reach on

their legislative measures – especially where the underlying clients have voluntarily elected to contract with and use the services of a non-EU account provider. Our fear is that, unless the Commission recognises the practical constraints on what can be effectively or properly achieved by EU account providers in these circumstances, the Directive's proposals will merely be a source of disrepute for EU laws – as the "obligations" contained in Principle 19 will be more respected in their breach, rather than their compliance. We are gravely concerned that this may undermine market confidence in European financial markets.

Q40: Do you think that a general authorisation to exercise and receive rights given by the account holder to the account provider [Principle 20] should be made subject to certain formal requirements? Please specify.

134. We do not consider that it is appropriate to prescribe formalities at EU level as these are a matter for national law relating to the exercise of property rights.
135. We also observe that the trend in EU law generally has been to treat formalities as a potential barrier to trade and to circumscribe their application: for example, the Financial Collateral Directive limits formalities required in national law for the recognition and enforcement of the rights of a collateral taker. A collateral taker may well be an account holder in relation to the collateral.

Q41: Should the status of account provider be subject to a specific authorisation [Principle 21]? If not, please explain why.

136. We agree in principle that, where an account provider performs the investment service of "safekeeping and administration" as a regular occupation or business, it is desirable and right for there to be regulatory supervision of account providers. We agree that authorisation under article 5 of MiFID is a suitable means of achieving that objective. However, for the reasons outlined in paragraphs 9 to 11 above, we do not accept that all account providers are properly considered to be performing this investment service; nor that the proposed Securities Law Directive is the appropriate vehicle to impose regulatory conduct of business requirements on account providers.
137. We would also welcome a clear statement that the status of a person as an account provider, and the rights of his account holders, would not be affected by the loss of any authorisation or other relevant regulatory status.

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

138. We do not think it is necessary for the service of providing a securities account, to the extent that function is performed as part of the investment activity of "safekeeping and administration of financial instruments", to be a full MiFID 'investment service'. There are many provisions of MiFID, which were designed with broking services in mind, which would then apply to account-providers who are not involved in anything other than a static (non-discretionary) safekeeping and administration function. For example, we think it unnecessary for account providers to be required to obtain information about the "appropriateness" of the service for the client. Furthermore, MiFID is undergoing a review, and a blanket application of MiFID may have unintended consequences and lead to new areas of legal uncertainty.

Q43: Do the terms used in this glossary [section 22] facilitate the understanding of the further envisaged Principles? If no, please explain why.

139. As a general observation, we believe that the terms used in the glossary do indeed facilitate the understanding of the scope and nature of the Principles. However, in the interests of maintaining global compatibility with other jurisdictions, we think it would be important for the substance of the definitions to correspond as closely as possible to the like definitions contained in the Geneva Securities Convention. Against that background, we would suggest the following changes to the definitions.

Paragraph (a) – "securities"

140. We would prefer to see the draft Directive adopt the approach taken by the Geneva Securities Convention as to the scope of financial assets that might potentially be covered by its provisions. We would avoid adoption of the MiFID list in Annex I Section C, as market practice will evolve and new types of securities will be created that are capable of being held in a securities account. To qualify as a "security", only two functional criteria need be met. First, they must be capable of being credited to securities accounts maintained by an account provider. Second, they must be capable of being acquired and disposed of in accordance with the provisions of paragraphs 1 and 5 of Principle 4.

141. We would, therefore, suggest a definition of "securities" in the following terms (by reference to Article 1(a) of the Geneva Securities Convention):

"'securities' means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Directive".

Paragraph (b) – "securities account"

142. We would suggest the deletion of the words "with that account provider" at the end of this definition. This is because in dematerialised systems, such as CREST for UK and Irish securities, the person who maintains the securities account (EUI, as operator of CREST) does not "hold" or "safeguard and administer" securities for the account holder (the CREST member). EUI is neither itself an account holder nor is it (or its nominee) a "legal holder" of domestic securities – it does not interpose itself in the holding chain as between the issuer and the account holder. An entry in the securities account does not, therefore, evidence holdings of the member "with" EUI. It evidences the title of the account holder as against the issuer (or, in Ireland, as against the transferor until registration of the account holder in the issuer register).

Paragraph (c) – "account provider"

143. For the reasons we set out in our response to Questions 41 and 42, as well as Question 1, we do not consider that it is either necessary or appropriate to require all account providers to be authorised for investment business in accordance with MiFID. The business model adopted by the account provider may not involve its provision of custody services or its provision of investment services as a regular occupation or business activity. Whether the activities of a particular account provider do result in its performance of safekeeping and administration of financial instruments for the account of clients within MiFID is not a matter to be determined by the proposed Directive – it is a regulatory issue for separate resolution. However, irrespective of whether the account provider performs functions that require it to be regulated, the

provisions of the proposed Directive (and the protections it affords to account holders) should apply to all account providers and the securities accounts maintained by them.

144. We would, therefore, avoid defining "account provider" by reference to its provision of custody services under authorisation through MiFID. We would prefer a more neutral, functional definition by reference to the core activities that are performed by an account provider, such as the following:

"account provider" means a person who in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity".

Paragraphs (k) and (l): "acquisition" and "disposition".

145. We do not consider that these definitions are necessary.

Paragraph (n) – "crediting"

146. For the reasons explained in our response to Question 11, we believe that it is appropriate to leave it to the account agreement or the rules of a securities settlement system to determine when securities are considered to be "credited" to a securities account. As a result, we suggest that this definition is either deleted or (as we would prefer) words along the following lines should be inserted at the end of the definition:

"as determined in accordance with the account agreement [for which a definition along the lines of Article 1(f) of the Geneva Securities Convention should be added] or the rules of a securities settlement system."

147. For similar reasons, we have a like response to the definition of "debiting".
148. We would note in this respect that the draftsman of the Geneva Securities Convention consciously avoided the inclusion of a definition of "credit" – see paragraphs 11-8, 11-9 and 11-12 of the draft Official Commentary. What operational or other steps should be taken to constitute a "credit" to a securities account should be determined by national law; and, according to the draft Official Commentary, "may be found in some legal or regulatory provisions of [national law] or, possibly, in the uniform rules of a securities settlement system".

Q44: Would you add other definitions to this glossary?

149. We consider that a number of additional definitions are required.

"Rules"

150. In the United Kingdom and Ireland, a number of key rules for the CREST systems are contained in legislation. In order to ensure that the proposed Principles have their intended effect in relation to the CREST rules (as "rules of a securities settlement system" within the Principles), we would suggest the addition of the following definition (which corresponds to the definition of "uniform rules" set out in Article 1(p) of the Geneva Securities Convention):

"rules" means, in relation to a securities settlement system, rules of the system (including system rules constituted by national law) which are common to the participants or to a class of participants and are publicly accessible."

"Maintains securities accounts"

151. In the light of the definition of account provider in section 22, paragraph (c), and for the reasons explained further in our response to Question 3, we suggest the addition of the following definition:

"maintains securities accounts' means to maintain, keep and enter up securities accounts and any other act in connection with the making, alteration and deletion of entries on securities accounts where:

- (a) the account provider may or may not in addition perform safekeeping functions in relation to the securities credited to the securities accounts; and
- (b) the securities accounts are not being maintained by the account provider on behalf of an issuer of securities under arrangements made between the account provider and the issuer."

152. The purpose of this insertion is two-fold. First, it makes clear that an account provider may maintain securities accounts without there being any requirement to deposit (immobilise) the securities with the account provider. The account provider need not interpose itself into the title chain or otherwise perform "safekeeping functions" by safeguarding and administering the underlying securities for the account of clients. An account provider may, therefore, perform pure "account maintenance functions" without at the same time performing "safekeeping functions". Secondly, the proposed Directive should not apply to registrars and others who act purely as agents for issuers in relation to the issuer register of securities. We have avoided the term "agent" in the definition, as this is a legal concept and so would be inconsistent with the "functional" approach adopted by the proposed Directive. We have used the concept of "arrangements made between the account provider and the issuer" to ensure that EUI continues to qualify as an "account provider". As EUI does not maintain the securities accounts under any obligation to the issuer contained in a contract or other arrangement with the issuer, but by virtue of its statutory obligations under the UK Uncertificated Securities Regulations 2001.

"Safekeeping functions"

153. To complement the insertion of the new definition for "maintains securities accounts", and to assist those cases where it should be provided that certain provisions of the proposed Directive apply only to the extent that the account provider performs "securities holding" functions, we suggest that the following additional definition be inserted:

"safekeeping functions' means the safekeeping and administering of securities for the account of clients."

Membership of the Working Party of the CLLS Financial Law Committee

This response has been prepared, on behalf of the Financial Law Committee, by the members of the following working party, whose individual specialist areas include advising on trade execution and clearing services, securities settlement systems, netting, financial collateral arrangements, custody and regulatory issues relating to financial markets:

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Details of the individuals and firms represented on the Financial Law Committee are set out in the Appendix.

Financial Law Committee
The City of London Law Society

21 January 2011

**THE CITY OF LONDON LAW SOCIETY
FINANCIAL LAW COMMITTEE**

Individuals and firms represented on this Committee are as follows:

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