



**HARMONISATION OF THE LEGAL FRAMEWORK FOR RIGHTS
EVIDENCED BY BOOK-ENTRIES IN RESPECT OF CERTAIN
FINANCIAL INSTRUMENTS IN THE EUROPEAN UNION**

**A REPORT BY THE
EUROPEAN FINANCIAL MARKET LAWYERS GROUP
EFMLG**

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NOTICE

This Report is published by the European Financial Market Lawyers Group (EFMLG). The members of the EFMLG, whose names are set out in the Annex, are each expert in the field of financial markets law in the legal system of their Member State with a high degree of practical experience. However, the members of the EFMLG participate in the work of the Group on a strictly personal basis. The views expressed in this paper are those of the members and do not necessarily reflect those of their institutions.

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Executive Summary

EFMLG recommendations

- *The EFMLG supports the Giovannini Group's proposal for an EU Securities Account Certainty project.*
- *Community legislative action should be taken to harmonise the legal regime governing the holding and transfer of financial instruments by way of book-entries in the EU.*
- *A statutory dematerialised holding regime based on book-entries, allowing for transfers of financial instruments under terms harmonised to a sufficient extent so that their differences do no longer constitute barriers to cross-border trading, would be instrumental to take full advantage of the effects of such harmonisation measure and of the huge advances in computer technology.*

Although the introduction of the single currency marks a very important step towards a fully integrated single market for financial services in the European Union (EU), that market is not yet a reality for the cross-border circulation of financial instruments within the EU. In particular, the absence of a harmonised legal regime governing the holding and transfer of financial instruments in the EU still gives rise to distortions.

Indirect holding systems have replaced most direct holding systems in today's securities markets. They can only function properly if the rights in respect of financial instruments are the subject of mere book entries at the various levels of this chain of holdings. However, the legal and operational framework of these indirect holding systems varies considerably from country to country. In addition, while some Member States continue to issue financial instruments in a material (paper) form, others have changed this practice as a result of the growing importance of book entries and the increasingly diminished role of paper certificates.

The European Central Bank established in 1999 the European Financial Markets Lawyers Group (EFMLG) to discuss initiatives that would lead to harmonisation of the EU financial markets. The absence of a harmonised legal regime governing the holding and transfer of financial instruments in the EU received particular attention.

The EFMLG strongly recommends legislative action to harmonise the legal regime governing the holding and transfer of financial instruments by way of book-entries, supported by a system

of statutory dematerialisation, in the EU. A statutory dematerialised holding regime based on book-entries would be instrumental to take full advantage of the huge advances in computer technology.

The EFMLG believes that Community legislation is needed to allow debt issued in dematerialised form to be transferred in an identical manner by way of book-entries throughout the EU and under terms harmonised to a sufficient extent so that their differences do no longer constitute barriers to cross-border trading in securities.

The EFMLG considers that a Community directive would be an appropriate tool for the facilitation of trade in financial instruments within the EU. It would improve the conditions for the trading of such assets through the creation of a single market for financial instruments and harmonise the conditions for holding such financial instruments and transferring them from one Member State to another.

A date would have to be fixed after which financial instruments would normally be represented only by a book-entry in their holders' name with an account administrator and custodian or an issuer, and no longer being represented by a paper certificate. Furthermore, there should be clear rules for the functions performed by the various types of intermediaries.

The effects of book-entries in securities accounts would need to have certain harmonised characteristics. In particular, a high degree of harmonisation is required for the following:

- the exact **nature and extent of an investor's right** as evidenced by a book-entry, and
- the **protection of investors' rights** to the maximum extent possible, even in the case of insolvency of the intermediary, and
- the full **tradability** of rights in securities as evidenced by book-entries, including the **protection of acquirers in good faith**, and
- the **safeguarding of the safety of a system** of holdings of securities by book-entries by double-entry bookkeeping and clear rules for movements of securities on accounts.

The EFMLG believes that a Community legal act, structured along the lines suggested above, would help to remove the barriers to further integration of the EU internal market for financial products, especially for securities. It should establish the conditions for transfers and cross-border movements of financial instruments, as well as legal certainty for investors when transferring their rights in respect of financial instruments. The proposed reform is not dealing with the issue of a full harmonisation of substantive securities laws, i.e. it does not advocate a

uniform securities code. It also does not affect prudential rules for participants' conduct of business in the securities markets. Furthermore, the project does not address competition aspects or advocate a specific infrastructure for the securities markets in Europe. Whilst the EFMLG believes that clear policy rules on such issues are crucial to the smooth functioning of the internal market, they are beyond the scope of this technical exercise. These issues should be left to more appropriate fora such as in the case of the on-going discussions on a modernisation of the Investment Services Directive (ISD).

Lastly, the EFMLG strongly supports the Giovannini Group's proposal for an EU Securities Account Certainty project. The EFMLG's proposal is intended to complement such project, if agreed upon by the Community.

The EFMLG strongly embraces this reform project as it is not only desirable to strengthen the internal market for financial instruments, but as it is technically feasible, as will be explained below.

Introduction

The increasing number of assets of households and enterprises held in the form of financial instruments highlights the importance of the financial market for the modern economy. This is why many EU Member States have modernised the infrastructure of their domestic securities industry in order to be efficient against growing international competition and cross-border transactions. In that context, two major developments to facilitate trade in financial instruments and to provide better conditions for the trading of such assets have to be highlighted: the introduction of “indirect holding systems” and the dematerialisation of securities.

Nevertheless, the lack of harmonisation of the legal framework governing financial instruments is a major obstacle to the creation of a single market for financial instruments. First, barriers to transferring and disposing of financial instruments cross-border arise mainly from differences in national legal cultures regarding the nature of rights relating to financial instruments and the form which financial instruments take. Second, investors lack legal certainty when transferring their rights in respect of financial instruments.

As a consequence, the EFMLG addressed at its meeting in September 2000 the issues of dematerialisation and of the holding of securities in the EU. The group concluded that:

- the barriers to harmonisation of the EU internal market, in particular for securities, arise as much from the differences between regulatory regimes as from the differences between the legal systems;
- the EFMLG’s work on the legal concepts of debt has shown that a number of these differences arise from different rules on the form in which and the terms under which debt may be issued and traded;
- the large advances in computer technology and the desire for a barrier-free internal market require a harmonised regime for holding and transferring securities by way of book-entries, whereby dematerialisation based on proprietary rights would be the most appropriate form for the issuance of debt securities; and
- Community legislation is needed to allow for debt issued in dematerialised form to be transferred in an identical manner through book-entries throughout the EU and under terms sufficiently harmonised to prevent barriers to cross-border securities trading.

Hence, the EFMLG decided to examine the possibilities for harmonisation of the legal framework for the removal of barriers to holding and transfer of securities in the EU internal market.

In this connection, the EFMLG took note of related work in this area, in particular by the Group of Thirty, the Commission's Giovannini Group and Unidroit.

The Group of Thirty, in its 2003 publication *Clearing and Settlement – A Plan of Action* emphasises in recommendation 15 the need to advance legal certainty over rights to securities, cash or collateral. In this respect, reference is made *inter alia* to the protection against intermediary insolvency risk and the finality of transfers or pledges of securities.

In addition, the Giovannini Group, established by the European Commission and composed of financial market experts, has examined the legal aspects of securities' clearing and settlement. The first Giovannini report of November 2001 identified three legal barriers to unrestricted cross-border holding and transferring of securities in the EU. These barriers are the differences in netting legislation, diverging or unclear conflicts of law rules and, most prominently, the absence of an EU-wide regime for proprietary rights in securities held with an intermediary. The differences in the legal treatment of netting and the differences in conflicts of law rules will be removed to a large extent by the implementation of Directive 2002/47/EC on financial collateral arrangements. However, the last barrier (absence of an EU-wide regime for proprietary rights in securities held with an intermediary) is likely to remain. Consequently, in its second report in 2003, the Giovannini Group proposes to establish an EU Securities Account Certainty project to propose solutions before the end of 2005.

Finally, in 2001, Unidroit has embarked on a project related to the harmonisation of substantive rules on transactions on transnational and connected capital markets at a global scale. In this context, a restricted study group was established to elaborate harmonised substantive rules regarding securities held with an intermediary. The study group is dealing *inter alia* with the nature of securities, trading issues and security interests.

This report will first summarise the background situation and outline the obstacles to be removed and the proposals that may be debated in that context (Section I - Background). Then it will make an attempt to propose a clear and realistic solution for harmonisation and the eventual form the Community legislation could take (Section II - Proposal for legal harmonisation).

I. Background

A. Factual situation

Traditionally, financial instruments have been held under direct holding systems. Under such systems, investors in financial instruments have a direct relationship with the issuer, either because they were registered in the records of the issuing company or because they or their direct custodian held physical certificates representing bearer securities.

Under this traditional system of direct holding, transfers of financial instruments were necessarily made by physical delivery thereof in paper form, which made such operations laborious, complex and costly in time and resources. Such operations also involved serious legal risks because financial instruments in physical form had to be moved about and, consequently, risked loss, theft or falsification.

In view of these disadvantages, the practice of holding and transferring financial instruments has evolved world-wide during at least the last two decades as mentioned above. Nowadays, the vast majority of financial instruments previously held in direct holding systems have been displaced by those held in indirect holding systems. In particular, under the newly created holding pattern an investor no longer has a direct link with the issuer and no longer has direct, physical possession of the certificate representing the financial instruments. Instead, the indirect holding system may involve a complex chain of custodian intermediaries.

Consequently, in indirect holding systems, the investor's right in respect of financial instruments is entered into the register or books of a financial intermediary who, in turn, has his right registered or booked with another financial intermediary. The last intermediary in this chain is: (i) either registered as a holder in respect of financial instruments in the books of the issuer, respectively in those of the issuer's account administrator; or (ii) holds the physical certificates or any other document representing the financial instruments.

Roughly summarised, the rights in respect of financial instruments are only recorded as book entries at the various levels of this chain of holdings. Another vital aspect of an indirect holding system is the centralisation of any physical holding of financial instruments (to the extent it is still existent) in special institutions such as central securities depositories. In practice, such special institutions are to a large extent the final and direct holder of the financial instruments

within the chain of intermediaries. This centralisation enables market players and investors to transfer rights in financial instruments by mere book entries, whereas any physical certificate (if still existent) representing the financial instruments would remain immobilised in the vaults of the central institution. Accordingly, the factual meaning of paper certificates for the representation of financial instruments has been rapidly declining in practice.

B. Current issues

The approaches Member States took in their respective legislation reacting to these revolutionary changes in the practice of holding financial instruments are very diverse. In many Member States neither the rules of substantive law governing securities transactions nor the conflicts of law rules have been brought up to date in an appropriate and concise manner to cope with the innovations that the indirect holding of financial instruments has brought about.

Furthermore, indirect holding systems have established a complex market infrastructure and sometimes a very complex chain of custodian intermediaries.

1. Market infrastructure

Within the post-trade environment, various types of actors play different roles, ranging from providing market infrastructure (e.g. central securities depositories) to participating in the market (e.g. custodians). However, the legal or operational nature of these actors has not been clearly defined. Frequently, a combination of roles may occur within one entity.

Central Securities Depositories (CSDs) historically play a core mission as notaries and operators of domestic securities settlement systems. In that function, they maintain accounting balances for all or part of issues of securities deposited with them and ensure the finality of securities bookkeeping in the appropriate jurisdictions. They traditionally provide core securities transactions, related cash movements and custody services. Moreover, they profit from strong ties with central counterparties and stock exchanges, ensuring a smooth and efficient processing of the transactions. Because of their central functions, they are susceptible to systemic risk, and are therefore subject to demanding regulations.

Custodians offer specialised services linked to the clearing, settlement and custody of securities (and associated cash), including banking and value-added products. They also may provide credit lines and manage all the risks associated with their activity: legal, credit, liquidity, and

operational risks. They are usually supervised financial institutions. In many financial markets, the activities of CSDs and custodians might overlap or be concentrated in one entity.

In particular, both CSDs and custodians may operate securities settlement systems (SSSs). The term SSS itself describes a range of services, and as such it does not denote any specific legal status. SSSs include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities.

In addition, two international central securities depositories (ICSDs) have played a historical role for Eurobonds. They first exclusively served the Eurobond markets, where the certificates or global notes were deposited in a depository bank common to both of the ICSDs. Consequently, the ICSDs intervened more as an agent for the securities and cash settlement between their members than as a real depository. They have since extended their services progressively to domestic government bonds, driven by commercial considerations and by the desire to attract new categories of securities. Nowadays they also play a role in the cross-border settlement of equity trades.

2. The form of financial instruments

While some Member States continue to issue financial instruments in a material (paper based) form, others have reflected the growing importance of book entries and the increasingly diminished role of paper certificates. Here, paper certificates have been substituted by a system of mere registration under which financial instruments are fully dematerialised and no longer represented by anything more than a book-entry with an account administrator and custodian, i.e. an institution which is authorised to act as a custodian and administrator of financial instruments. However, this type of registration system is often limited in its material scope of application. Many Member States have implemented it only with respect to certain financial instruments issued by governments for debt management purposes. Others have included additional, enumeratively listed financial instruments. Some countries have stopped short of providing full dematerialisation, with the provision of immobilised global certificates. These systems still maintain the keeping of a physical security, representing the total issue, whilst the investors' actual holdings are represented by mere book-entries, thus resembling in effect full dematerialisation.

One crucial aspect concerning the harmonisation of Member States' legal systems is the statutory dematerialisation of financial instruments. In respect of whether or not financial instruments

should mandatory be in dematerialised form or whether paper certificates should also be allowed, one has to consider whether Community legislation should impose dematerialisation or allow Member States to opt for whichever of the two regimes they consider most appropriate. The Community harmonisation rules will in any event apply to dematerialised systems and especially to the CSDs operating under a supervisory authority in each Member State.

As a general remark, it is not intended to bring about a revolution in the securities sphere. In principle, financial instruments are now held and moved on the basis of book entries. It might nevertheless be necessary to avoid disrupting certain habits on the side of investors who wish to physically hold their securities in paper form. Accordingly, it should be considered whether the holders of dematerialised financial instruments could opt to request conversions of such financial into paper form at their own expense. Allowing such an option would to a certain extent run counter to the very rationale of introducing a dematerialised securities regime and would involve expenditure and complexity. Consequently, rather than being mandatory, this option should be facultative for the CSD operator.

In any event, a date will have to be fixed after which financial instruments will as a rule be represented only by a book-entry in the name of its holders with an account administrator and custodian or an issuer, and no longer by a paper certificate.

Moreover, if it is felt to be appropriate to leave open the possibility for investors to hold their financial instruments in registered or in bearer form, both terms should be clearly defined as they may have very different meanings within the EU.

Although the term “bearer securities” relates mainly to the sphere of financial instruments in paper form, it can still be used in the previously accepted sense of anonymity vis-à-vis the issuer.

Such holding in bearer form is understood to include cases where the issuer of the financial instruments does not know the name of the final investor, who holds his rights in respect of the financial instruments only by virtue of a legal relationship with an intermediate account administrator and custodian.

In contrast, the practice of holding securities in registered form should be reserved for situations in which the investor has a direct and immediate relationship with the issuer, so that his rights in respect of financial instruments do not depend on a relationship with a financial intermediary. Even in the countries which completely replaced physical securities with book-entries, registered securities may be maintained as a legal form for share ownership, and will therefore be

submitted to a direct holding system. Nevertheless as dematerialised securities, they will be represented by book-entries and subject to book-entry transfer.

3. Legal nature of rights

Extremely complex and diverging situations also exist in the EU Member States as far as the legal nature of rights in respect of financial instruments is concerned. While under the direct holding system, a direct right of ownership in specific certificates representing financial instruments was predominant, under indirect holding systems an investor's right in respect of financial instruments has more the character of intangible property rights in fungible or pooled financial instruments held in the vaults of central securities depositories or one of the financial intermediaries operating as account administrator and custodian. What these intangible property rights have in common under most Member States' jurisdictions is that they are not related to specific certificates representing the financial instruments. Instead the investor is only entitled to receive financial instruments of the same number and kind, i.e. equivalent to those recorded on his account. However, the legal interpretation of these rights is very different from one Member State to another. Some define rights as co-ownership rights, others as mere contractual rights and finally some treat them as fiduciary rights under a trust or other fiduciary arrangement.

The contemporary notion of securities is based on the principle of direct holding in relation to which the issuer of securities and their beneficiary are privy. The introduction of the *litteralita* principle transposed principles hitherto applying to tangible movable property to proprietary rights in material securities. They were introduced in response to the then perceived new need in the field of commercial transactions as a refinement of the former rules governing property rights in tangible movables. These principles adapted traditional civil law concepts of property rights in corporeal assets to the needs of the new, evolving commercial law.

The rules emanating from the (revolutionary at the time) meeting of these two strands reflect fundamental public policy choices such as, for example, favouring the facilitation of transactions over the pursuit of the competing objective of security of transactions. In order to facilitate transactions, several exceptions to fundamental principles of property law have evolved in the context of securities, as for instance the exception allowing the *bona fide* acquisition of property in movables *a non domino*.

The advent of indirect holding of rights in (dematerialised) securities entails that the policy objectives hitherto served by the rules of law that have been developed in the context of

securities in material form can no longer be met. Furthermore, the rules applicable to the new regime give rise to some legal uncertainty. For example, it is far from certain which rules apply to dematerialised securities in book-entry form: those pertaining to movables or those applicable in the case of immaterial rights. The transaction-friendly provisions outlined above have been developed to facilitate transactions in tangible movables and commercial paper, to the detriment of an overly strict adherence to the security of transactions. It follows that applying traditional property law notions to dematerialised securities would risk introducing a rigid and inflexible structure depriving transactions of the required flexibility.

Whilst the traditional concept of ownership of paper securities can be easily understood, it is, on the other hand, more difficult to explain how a person can be the “owner” of book entries in an account kept by a financial intermediary. In contrast to a paper security, a book-entry cannot be as such “held” or “possessed”. Strictly speaking, it is impossible for a right *in rem* to exist in respect of book-entries and therefore ownership is based on a legal fiction.

In this connection, it should be noted that the principle of *litteralita* (applying to material securities and granting specific rights to their beneficiary as opposed to their issuer) in itself constitutes a legal fiction. Thus, the rights which material securities physically incorporate could be considered incorporated in the book entries. This does not require a logical concession any greater than currently made as a matter of course in the case of material securities. The only difference is that legal fictions have long been part of the corpus of legal rules applying to material securities, thus no longer being situated at the heart of legal debate, whereas the same is not true of book entries. At the end of the day, it is not a question of legal categorisation, but rather one of substance in respect of the legal implications for the issuer, the account administrator and custodian, and the owner of dematerialised securities in a regulated book-entry based system.

Under the currently very complex and synthetic nature of an investor’s interest in indirectly-held financial instruments under the law of one Member State can lead to deviating characterisations of that interest under the law of other Member States.

The risk of time lags in the national lawmakers’ responses to the new challenge of indirect holding is far from acceptable for the EU because it risks generating considerable legal uncertainty. Therefore, it is submitted that the moment is right for the introduction, through Community harmonising measures, of a statutory system of dispositions of indirectly held financial instruments.

4. Dispositions of financial instruments and protection of third party acquirers

No less complex is the legal construction of transfers and pledges of rights in respect of financial instruments. While in practice dispositions of such rights are effected by mere book entries, the legal explanation thereof is in most Member States still influenced by a system based on the physical delivery of the financial instruments. However, with financial instruments being immobilised or even dematerialised, concepts like “physical holding” and “delivery” do not fit any more satisfactorily into the context for the purposes of immobilising or dematerialising financial instruments in an indirect holding system without creating legal fictions. Only a few Member States responded by introducing a statutory system for dispositions of indirectly held financial instruments.

Moreover, investors lack legal certainty concerning the exact point in time at which their rights in respect of financial instruments are transferred. Currently, rights may be transferred at different points of time. A transfer may be completed at the time of the transaction between the investor and the person transmitting orders for him. Alternatively, the transfer may take place when the selling investor’s account with his account administrator and custodian is debited and/or the purchasing investor’s account with his account administrator and custodian is correspondingly credited. Yet another possibility is to focus on the time of delivery of the financial instruments to the account held by the CSD or a registrar in the name of the relevant account administrator and custodian.

Finally, as regards the protection of third-party acquirers, Member States have adopted increasingly divergent solutions. In order to foster tradability of financial instruments, most Member States protect an acquirer of financial instruments or a pledgee thereof which has acquired an item of property *a non domino*, if they have acted in good faith.

5. Conflict of laws

Not only are the Member States’ substantive laws applying to transactions of financial instruments diverse, but it is unclear which law applies to such transactions.

In the absence of any harmonisation, investor rights in respect of financial instruments are still determined by differing and sometimes conflicting private international law rules. Due to their origin in physical certificates, the predominant rule in the past was the *lex rei sitae* principle. But

with the disappearing of physical pieces of paper, the relevance and practicability of such rule has dwindled. Only recently, the EU and the Member States (by virtue of Article 9(2) of the Settlement Finality Directive and Article 9 of the Collateral Directive) have acknowledged the growing relevance of intermediate holdings by using the place of the relevant investor's account with his intermediary to determine the law applying to the investor's securities holding. This harmonisation is, however, limited to securities provided as collateral in connection with a system, a central bank or a financial collateral transaction. In addition, before the investor disposes of financial instruments by way of collateral or transfers them to an acquirer, they will continue to be covered by the law applicable to his holding of the securities. As a result, the transferor's loss of rights may not take place at the same time as the transferee's acquisition of rights. Consequently, the disposition of financial instruments will continue to be subject to disparate legal regimes, making it difficult for investors to ascertain the precise scope of their rights in respect of financial instruments.

In order to make the law applying to dispositions of financial instruments more predictable at a global scale, the Hague Conference on Private International Law finalised on 17 December 2002 a convention introducing a new conflicts of law rule. The Convention is based on the principle that the parties to an account agreement can choose the law governing all proprietary aspects related to securities held on that securities account. This rule deviates from the existing Community law, according to which the law governing proprietary aspects of dealings in securities held with an intermediary is determined by the location of the securities account (the PRIMA approach). The choice of the parties is limited only by the requirement that the intermediary needs to maintain an office in the State whose law has been chosen. At such office, the intermediary needs to perform some functions or other regular activities of maintaining securities accounts. However, it is not necessary to perform any functions relating to the specific securities account at such designated office. However, the Hague Convention, which is not yet ratified by the EU and the Member States will not be in a position to change the rules of substantive securities law.

Thus, the lack of a European uniform framework for dematerialisation of financial instruments and rights evidenced by book-entries remain a major obstacle to the creation of an integrated single European market for financial instruments.

II. Proposal for legal harmonisation

The proposal for legal harmonisation is based on two pillars: on the one hand specific rules for the organisation of the securities infrastructure, and on the other hand the harmonisation of the effects of book-entries.

A. Rules for the organisation of the securities infrastructure

1. Role and functions of the participants

The investors will only trust any new harmonised legal regime if a secure holding is ensured throughout all layers of the intermediary chain and if all of the institutions involved work together properly and are reliable.

Rules on book-entry holding of financial instruments should determine very precisely the obligations of those making up the chain of holdings. A harmonised system should be based on accurate accounts in respect of the assets forming the subject of book entries in the names of their holders. Member State competent authorities need to adequately monitor the activities of account administrators and custodians, CSDs, securities settlement systems and registrars.

It is necessary to clearly identify the functions of each participant. Account administration and custody consists, first, in making book entries for financial instruments in the names of their holders, that is to say establishing the holder's rights in respect of those financial instruments. Second, it involves keeping the corresponding assets in custody, in accordance with the arrangements appropriate to each financial instrument.

More specifically, proof of the existence of rights in respect of a financial instrument forming the subject of a book entry should be established by the account administrator and custodian.

Book entries for financial instruments may be made either with an account administrator and custodian, in which case they could be referred to as bearer financial instruments, or with an issuer, in which case they could be referred to as registered financial instruments.

Hence only the following entities should be authorised to administer accounts for financial instruments in the names of their holders:

- credit institutions as defined in Article 1, No. 1 of Directive 2000/12/EC (Banking Directive) as amended, including the institutions listed in Article 2(2) of that Directive¹,
- investment firms as defined in Article 1(2) of Directive 93/22/EEC (ISD) as amended by Directive 97/9/EC²,
- and if and to the extent the Member States so provide, CSDs not constituted as a credit institution.

In addition to the entities referred to above, the following could be authorised to act as account administrators and custodians:

- corporate issuers, as regards account keeping and custody, in registered form, of the financial instruments issued by them,
- and possibly supervised insurance undertakings.

It should be possible for book entries for financial instruments to be made either with any of the eligible entities listed above. However, according to the principles established above in relation to account keeping and custody functions, a CSD or a registrar should only be regarded as a custodian of financial instruments on behalf of investors, if they maintain customer accounts. This function would have to be distinct from their primary role of ensuring the availability of the financial instruments covered by entries in their books for the accounts of other account administrators and custodians, so as to facilitate their movement between different account administrators and custodians.

Consequently, to the extent that notary and registrar functions are performed, these should be seen as a service in the public interest subject to a more stringent supervisory regime than the maintaining of customer accounts.

It is proposed to require CSD customers, whether investment firms or credit institutions, to keep two separate accounts: an own account and an investor account. As a minimum, where investment firms or credit institutions act as custodians, the ISD and the Banking Directive provisions on segregation should apply. Moreover, they should, where applicable, inform their clients of the possibility to chose an end customer accounts, instead of an omnibus customer account for their titles.

¹ Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ L 126, 26.5.2000, p. 1).

² Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11.6.1993, p. 27). Directive as last amended by Directive 97/9/EC of the European Parliament and of the Council (OJ L 84, 26.3.1977, p. 22).

2. Security of the system

a) Double-entry bookkeeping

Financial instruments of the same category should be the subject of book entries in the issuer's name with a CSD or with a registrar.

The totality of the assets of any one issue of financial instruments of holders with an account administrator and custodian for the same category must be equal to the totality of the account administrator and custodian's assets placed with the CSD or registrar with which it has opened a financial instruments account.

Similarly, and in order to ensure the greatest possible level of protection for investors, it is important for assets lodged with CSDs or registrars to be recorded in such a way as to differentiate between financial instruments held on behalf of the clients of account administrators and custodians, and those held by the latter on their own behalf.

The object of the reform must be to introduce rules applying to book entries in central securities depositories approved and supervised by the relevant Member State authorities. Rules may also be introduced for book entries in investment firms and credit institutions acting as custodians. Nevertheless, the ISD prudential rules concerning their organisational structure as well as rules of conduct must be respected.

To determine and monitor the rights of holders, the financial instruments accounts kept by the account administrators and custodians and of issuers keeping accounts for their registered financial instruments should be kept in accordance with the rules of double-entry accounting. The nomenclature for such accounts and the governing legal framework should be the subject of a harmonised process at European level, e.g. by the Committee of European Securities Regulators (CESR). Those principles should include the requirement that measures are taken to preclude the circulation of more rights in respect of financial instruments than actually exist.

b) Movement of financial instruments

Account administrators and custodians should ensure that, subject to the application of any provision of a law or regulation to the contrary, any movement of financial instruments affecting

a holder's account should be effected solely on their or their representative's instructions or, in the event of transfer, those of a duly authorised third party.

Every operation capable of creating or modifying an account holder's rights should be recorded as soon as the right is ascertained. Where the operation involves a movement of cash or of rights, on the one hand, and, on the other, a corresponding movement of financial instruments, the accounting entries for such movements should be linked to each other.

Account administrators and custodians should provide for custody and management of the financial instruments entrusted to them on behalf of their holders. In that connection, their task should be to maintain unchanged the rights in respect of the financial instruments which have been entrusted to them by their clients and restore them in the same state.

B. Harmonisation of the effects of book-entries

1. Scope

The scope of legal harmonisation should be as broad as possible to include all kinds of financial instruments, including negotiable money market instruments, no matter who the issuers are, provided that they are transferable by book-entry.

The term "financial instruments" should be understood broadly to also include shares, instruments issued in the context of initial placements or by collective investment undertakings even where they are not admitted to trade on a regulated market. Similarly, money-market instruments, such as certificates of deposit, treasury bonds and any other refinancing instruments issued by Member States or central banks, treasury bills and negotiable medium term notes, should be covered to the extent that they can be traded on simplified terms under commercial law, although they are not necessarily admitted to a regulated market.

Financial instruments of a purely contractual nature, e.g. non-negotiable money-market instruments, financial futures contracts, forward rate agreements, interest rates, currency and equity swaps and options, including equivalent cash-settled instruments, should not be covered by the scope of this initiative. Such instruments do not necessarily share the specifics related to the highly tradable financial instruments mentioned above. Furthermore, sub-participation rights should be excluded from the scope of this initiative as well.

To safeguard the required legal certainty for the practical application of the suggested regime, a clear and transparent designation of the material scope of application will be essential.

2. Form and nature of financial instruments

An initiative for legal harmonisation of rules related to the holding of financial instruments by way of book-entries within the EU should cover the most important issues pertaining to the holding and (cross-border) dispositions of financial instruments. The special characteristics of the indirect holding system for financial instruments need to be taken in account. Furthermore, it is necessary to concentrate on matters where to some extent the Member States may already converge, at least in practical terms.

One of the obstacles such an initiative would have to overcome are the legal divergence in the conditions applying to transfers and cross-border movements of financial instruments. However, this concerns mainly the nature of rights relating to financial instruments and the form that these financial instruments take.

Concerning the form of financial instruments, the legal regime should encourage a statutory system under which financial instruments are held in dematerialised form based on proprietary rights, as opposed to purely contractual dematerialisation. In the latter case, contractual rights would under most jurisdictions hinder their acquisition *a non domino*, even if the acquirer has acted in good faith. This would impair the tradability of financial instruments.

The abolition of financial instruments in bearer form would not impair the efficient prevention of money laundering because, although the holder of financial instruments remains anonymous as far as the issuer is concerned, his identity is known to the relevant account administrator and custodian.

The suggested regime is focusing on the holding of securities on the level of the intermediaries rather than on the form in which financial instruments are being issued. It is noted, however, that a system of full statutory dematerialisation, whereby already the issue of an financial instrument would occur in a completely dematerialised form, would be best suited to take full advantage of the effects of this harmonisation measure and of the huge advances in computer technology. However, for the time being, Member States may decide to retain an optional system which provides for a issuance of book-entry financial instruments in a physical form.

There is as a clear need for modernisation and full harmonisation of the substantive law on book-entry securities. However, in the Member States, the legal nature of securities and the rights derived from their issue on the basis of legal regimes which recognise co-ownership rights. It seems unlikely that a full harmonisation is possible in the short-term because the scope of these rights is influenced to a large extent by strong legal traditions in the Member States, and will additionally depend on the provisions of the custody agreements between investors and their intermediary. It seems therefore to be appropriate for each Member State to retain the responsibility for defining the legal relationship between an investor and an account administrator and custodian in accordance with its own legal tradition, provided that a number of common criteria are met. This is, however, without prejudice to other related reform activities, whose medium and long-term efforts for further harmonisation of substantive securities laws merits all possible support.

3. Effects of the book-entries registration

As a consequence, we propose an easier to implement approach focusing on harmonising the effects of the booking on a securities account, that is the (proprietary) rights evidenced by book-entry, instead of the legal nature of the booking on the securities account.

Practice shows that whatever the legal nature of financial instruments, they circulate by transfer between intermediaries. Harmonising the effects of the booking of securities does not require a common definition of financial instruments and therefore national qualifications in this field can remain.

However, one would still need to determine the relevant book-entry. One possible approach would be to treat only the securities settlement systems as relevant intermediaries and to restrict the circulation of securities to settlement systems. However, we support a more comprehensive approach focusing on the account administrator and custodian's role of establishing and protecting the relationship between the investor and the account holder. In accordance with the Giovannini Group's proposals, legal significance should be given to accounts maintained by those who hold securities for others as this concept reflects the reality of modern securities markets. Through this approach, the extent and exact nature of rights of investors whose securities are held on an account with an intermediary and of the rights of third parties will be clear and transparent.

a) **Protection of investors' rights in respect of securities**

In order to promote the tradability of financial instruments, it has to be ascertained that an investor's proprietary rights in respect of financial instruments are sufficiently protected as follows.

- An investor who holds a financial instrument should be entitled to receive from their account administrator and custodian or, where appropriate, the issuer, financial instruments equivalent to those recorded in their account. This should apply even if the financial instruments account of the account administrator and custodian with the CSD is not in credit, provided, however, that it is ensured that a volume of financial instruments exceeding the one registered with the CSD of issue does not circulate on the market.
- The use of rights in respect of book entries by an account administrator and custodian should be possible only with the express consent of the holder of rights of the financial instruments and of secured third parties.

Account administrators and custodians should ensure that, subject to the application of any provision of a law or regulation to the contrary, any movement of financial instruments affecting a holder's account is effected solely on their or their representative's instructions or (e.g. in the event of transfer or pledge) on those of any other duly authorised third party.

An account administrator and custodian should not be entitled to make use of the holder's rights deriving from a book-entry without the holder's or authorised third party's express authorisation. In particular, an account administrator and custodian should be prohibited from moving financial instruments from the account of a client to an own account without such express authorisation.

Breach of this obligation should not render void any dispositions effected by the account administrator and custodian. However, the holder's right to claim damages under the general law and the right of the Member States to impose criminal penalties should not thereby be impaired.

- In case of default of an account administrator and custodian, and without prejudice to the substantive rules of the applicable insolvency law, the account holder should obtain a direct right in respect of the corresponding entries in the custodian and account administrator's account with the CSD.

Creditors of a defaulting account administrator and custodian should not be entitled to enforce any right whatsoever in respect of entries in the account administrator's accounts to the extent necessary to achieve the account holders' satisfaction.

Furthermore, creditors of a defaulting account administrator and custodian should not be entitled under any circumstances to enforce any right whatsoever in respect of entries in the custodian and account administrator's account with the CSD. Instead, such rights are appropriated exclusively to investors in the same category of financial instruments.

- Account administrators and custodians maintaining securities accounts should have adequate protection mechanisms in place (including those arising from their supervisory regime) to avoid shortfalls and to deal with them should they occur. In case of shortfalls, investors in the same category of financial instruments should be satisfied on a pro rata basis.

b) Transfer of rights in respect of financial instruments

To facilitate dispositions of financial instruments, transfers of rights in respect of the financial instruments entered in an account in the name of the holder should be effected by a book-entry in the form of a transfer from account to account with the relevant account administrators and custodians. Where the financial instruments will continue to be represented in physical form without book-entries, transfers of rights should take place in accordance with the traditional legal framework specific to each financial instrument in each Member State.

It is noted that Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements³ already provides a simplified legal framework for collateral transactions. This framework could be extended to general application.

The following principles should apply to the account holder and custodian even though we are aware that this issue will fall within the competence of regulators (and, if the suggestion to have a new Community instrument is being followed, should be dealt with on the regulators' level 2 of the Lamfalussy procedure):

- The purchaser's account administrator and custodian should debit the latter's cash account in its books with the sum corresponding to the amount of the transaction. Furthermore, they should, in accordance with certain minimum conditions to be further defined, send a payment instruction to the delivery settlement system under the conditions laid down by the relevant

³ Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (OJ L 148, 27.6.2002, p. 43).

CSD or registrar. Correspondingly, the purchaser's account administrator and custodian should, in the purchaser's name, credit the financial instruments account accordingly.

- The seller's account administrator and custodian should debit the latter's financial instruments account in its books with the number of rights involved in the transaction. They should, if applicable and under certain minimum conditions to be further defined, send a delivery instruction to the relevant delivery settlement system under the conditions laid down by the relevant central securities depository or registrar. Correspondingly, the seller's account administrator and custodian should credit the seller's cash account with a sum corresponding to the amount of the transaction.

In any case, account administrators and custodians should, where applicable, observe the Delivery versus Payment principle in respect to the settlement of any transactions performed thereunder.

c) Attachment of rights and measures blocking them

In the absence of harmonisation, and having regard to the basis on which financial instruments are held, the question arises as to how a creditor may attach or claim an investor's right in respect of financial instruments held at a higher level in the chain of holdings (upper-tier attachment). Therefore, we propose that any attachment by a creditor of rights deriving from a book-entry in the name of the holder, or any blocking measure having equivalent effect, operate against the latter's account administrator and custodian. The scope and effect of the attachment will remain subject to the qualification under the applicable law.

Moreover, account administrators and custodians should not be in a position to invoke banking secrecy or confidentiality vis-à-vis any creditor seeking to obtain an attachment order against an account holder or any relevant supervisory authority.

d) Pledging of rights in respect of financial instruments

The effectiveness vis-à-vis third parties of any pledge on the rights deriving from a book-entry in the name of the holder should be a matter for the holder's account administrator and custodian. The scope and effect of the pledge will remain subject to the qualification under the applicable law.

Again, it is noted that Directive 2002/47/EC provides a simplified legal framework for financial collateral arrangements as regards the establishment and realisation of collateral, and in particular the re-use of pledged assets which could be extended to general application.

e) Protection of third parties acquiring in good faith

As regards to the protection of third-party acquirers, the increasing number of solutions adopted in the Member States to protect an acquirer in good faith is a source of uncertainty for investors. Whilst most European legal systems apply the principle that no person may transfer a more extensive entitlement than that which is vested in them (*nemo dat quod non habet* or rather *nemo plus juris ad alium transferre potest quam ipse habet*), that principle is nevertheless not absolute. A number of Member States have departed from that principle in order to promote trade in movable property, by providing that a purchaser of movable property must be protected if he has acted in good faith. Thus, where the possessor has acquired an item of property *a non domino* and has acted in good faith, his possession enables him to acquire ownership instantly. This rules out any possibility of a claim based on the preference granted to a possessor over the owner, a situation which runs counter to the maxim *nemo plus juris ad alium transferre potest quam ipse habet*. If the possessor has received the property from its true owner, civil law generally presumes that he received good title to it; the possessor of an item of property *a domino* is presumed to be its owner, but that is a mere presumption.

However, it would seem rather inconsistent for the acquirer of financial instruments or a pledgee thereof to find that their rights were called into question even though the civil law of most of the Member State protects the acquirer of movable property. A simple and clear rule should therefore be adopted which, whilst promoting the tradability of financial instruments, also protects acquirers in good faith. It is therefore necessary to promote the “dynamic” certainty of rights in order to ensure their “static” certainty. An acquirer who is unaware of the rights of others in respect of financial instruments should be accorded preference over the *verus dominus*, pledgees and, more generally, all persons claiming a right in respect of the financial instruments concerned.

We feel that strict adherence to the principle of good faith is likely to generate serious difficulties, especially in the context of chain transfers in and out of pool accounts where fungibility necessarily entails the practical impossibility of establishing whether or not the title transfers have been acquired in *bona* or, indeed, *mala fides*.

Instead, Community harmonising measures should ensure that account administrators and custodians (whether CSDs, investment firms or credit institutions) invariably operate subject to strict rules pertaining to the cross checking of the credentials of the alleged owner so that whatever transfers have taken place are valid and enforceable *erga omnes*. In other words, the issue of good faith, albeit still current, should not be considered as the only deciding issue. The validity of transfers should be considered not only in the light of the transferor's good title and/or the transferee's good faith but, rather more broadly, in order to favour the finality and irrevocability of transfers of securities. The primacy of good faith should thus be substituted by the mandatory nature of the legal duties and obligations undertaken by the account administrators and custodians functioning as supervised entities. It is precisely this liability vis-à-vis the injured party in the event that the account operator should, for whatever reason, fail to fulfil its obligations, which should be the overriding concern. Besides, a transfer of securities may not exclusively be affected by the transferor's bad faith in the case of a transfer *a non domino* (i.e. in case of lack of good title of the transferor), given that a series of other defects, undetectable in the absence of a proper regulatory framework for the operation of account administrators at large, might have an impact thereon.

Nobody then should be entitled to challenge rights deriving from a book-entry which were acquired by a third party in good faith. Book entries should only be challenged if the securities are kept in the account of a *mala fide* transferee and the account operator has been notified of the legal challenge in question prior to the performance of any transaction over the financial instruments in question.

III. Form of Community action

The initiative supports the further integration of the EU financial markets. The proposal will therefore support the free movement of capital provided for in Articles 56 to 60 and the freedom to provide services under Article 49 of the Treaty. Consequently, the initiative would fall within the Community's exclusive competence according to Article 95 of the Treaty and is of importance for the functioning of the internal market.

The EFMLG has considered the best form that a Community legal act in this field could take. In this regard, a regulation and a directive have been considered.

The advantage of a Community regulation would be that it allows entry into force at exactly the same time in all Member States of the EU whereas in the case of a directive it is not possible to

set a common date for transposition, a situation which leads: (i) to non-harmonised entry into force; and (ii) the need to deal with cases of countries which have not yet transposed a directive within the time limit.

On the one hand a regulation would introduce a rigid, albeit fully harmonised, system for the effects of book-entries for financial instruments on top of existing national legal systems. On the other hand, a directive would have the advantage that, due to the need for a national implementation, the specifics of Member States' jurisdiction could be taken into account, thus ensuring consistency with the existing legal systems.

Furthermore, in accordance with the Lamfalussy approach, the comitology procedure could elaborate the technical details of such a new legal framework.

Conclusions and follow-up

Hence the EFMLG strongly recommends Community legislation to create a harmonised legal regime for the holding and transfer of financial instruments by way of book-entries, supported by a system of statutory dematerialisation, in the EU. A statutory dematerialised holding regime based on book-entries would take full advantage of the huge advances in computer technology.

This regime cannot be achieved on a contractual basis alone. Community legislation would be needed to allow financial instruments to be issued in dematerialised form and transferred by book-entries in an identical manner throughout the EU and under terms harmonised to a extent sufficient that their differences no longer constitute a barrier to cross-border securities trading.

In the views of the EFMLG, a Community legal act structured in this way would help to remove the barriers to a further integration of the EU internal market for financial products, in particular for securities. It would establish the conditions for transfers and cross-border movements of financial instruments and increase legal certainty for investors when transferring their rights in respect of financial instruments.

The EFMLG considers that a Community directive would be an appropriate tool to facilitate trade in financial instruments within the EU, by providing the conditions for the trading of such assets in a truly single market for financial instruments. It would also harmonise the conditions for the holding of such financial instruments and their transfer from one Member State to another.

Moreover, the EFMLG strongly supports the Giovannini group's proposal for an EU Securities Account Certainty project. The EFMLG's proposal should be seen as complementary to this

project. The EFMLG hopes that this report's elements of a possible harmonised regime for the holding and transfer of financial instruments by way of book-entries, supported by a system of statutory dematerialisation, will provide inspiration and background material for the drafting of detailed proposals in the context of the Securities Account Certainty project.

As explained in detail above, the EFMLG firmly believes that this reform project is not only highly desirable for the internal market for financial instruments, but that it is also technically feasible.

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THE SUB-GROUP OF THE EFMLG ON BOOK-ENTRY TRANSFERS AND DEMATERIALISATION

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