EUROPEAN CENTRAL BANK

DIRECTORATE GENERAL - LEGAL SERVICES

To the Members of the
European Financial Market Lawyers Group

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Dematerialisation

This paper introduces material which is intended to commence the work that the EFMLG will do related to dematerialisation of securities. At the first meeting, the group discussed the implications of national legal differences in the concept and definition of securities, namely of debt instruments and asset-backed securities. The group felt that a smooth functioning of the euro-wide capital markets would require that an attempt is made to narrow down the existing legal differences as far as possible. Therefore, it was decided that the grouping could analyse whether some EU-wide standards for national securities could be established. In addition, the group identified that there are significant variances across the EU, and wider, of the extent to which dematerialised securities exist and are traded. It was therefore agreed that this topic should be investigated further.

As a matter of definition, dematerialisation involves the abandonment of physical paper in favour of the electronic medium. In practice, the distinction between paper and electronic instruments is not always as clear cut as one might wish.

Therefore, it seems that an appropriate starting point for the EFMLG examination is to enquire about the current state of the overall dematerialisation process throughout the EU financial markets. To this end, we may pose the following questions:

1. To what extent is dematerialisation already in existence in each EU legal system?
2. What plans are there to promote further dematerialisation?

In relation to question one, provisional answers have been supplied by the ECB to the question whether legislation allows for dematerialisation. In addition, the question needs to be asked for each country whether legislation is needed to allow for it, or whether normal rules to freedom of contract would permit it without legislation. It is suggested that EFMLG members may therefore check and supplement as appropriate from a market perspective these provisional answers.

In relation to question two, there follows to assist in this process a general description of the state of dematerialisation and the legal status of dematerialised securities in the EU, focusing in particular on the lessons that can be learned from the statutory introduction or rules specifically designed to facilitate the operation of the two ICSDs used in the international market.

BACKGROUND PAPER ON DEMATERIALISATION AND A PROVISIONAL OVERVIEW PER EU COUNTRY

I. Introduction

In preparation of our European Financial Markets Lawyers Group meeting on 11 October in Frankfurt, enclosed please find enclose a table summarising for each of the 15 Member States of the EU whether national legislation provides or allows for the issuance of dematerialised securities.

This legal assessment is based on research performed by ECB/NCB lawyers with respect to their jurisdiction of competence. It can be derived from the enclosed table that the issuance of securities in dematerialised form is possible to a certain extent in all Member States. Differences in Member States between dematerialised securities on the one hand and bearer and registered securities on the other exist mainly at the level of the nature of the entities that are allowed to issue securities in dematerialised form (e.g. in Germany, only the Federal government and the ECB are authorised to issue securities in fully dematerialised form) and at the level of clearing and settlement.

II. General considerations

Traditionally, securities have been issued in paper form where the right of ownership or the claim was incorporated in the physical paper. This approach entailed a series of inconveniences, e.g. 1) in case of a sale of securities the seller had to deliver the physical securities to the buyer which implied delays and risks of loss and theft (recognising that the risk of loss and theft is not limited to the moment of delivery); 2) in case of a deposit of securities with a bank, the bank had to keep the securities deposited by each of its clients separate in order to be able to re-deliver at any time exactly the same securities as those initially deposited; 3) for tax authorities, bearer securities have the disadvantage of allowing for the anonymous creation of important wealth without tax authorities being aware of it (It could also be noted here that in some countries the investor in dematerialised securities remains anonymous by virtue of a bank secrecy which can also prohibit disclosure of information to the tax administration.).

The joint pressures from the market and from tax authorities have caused an evolution towards a progressive dematerialisation of securities.

The first initiatives, achieving "immobilisation" rather than full dematerialisation, were taken by Germany in 1937 with the creation of "Kassenvereine" with "Sammelverwahrung" and by France in 1941 with the creation of C.C.D.V.T. ("Caisse centrale de dépôts et virements de titres") succeeded in

1949 by the set-up of SICOVAM ("Société interprofessionnelle pour la compensation des valeurs mobiliès") and completed in 1981 with a law introducing, under pressure of the tax authorities, the mandatory dematerialisation of securities.

These German and French precedents have served as a basis for the Belgian Royal Decree No. 62 of 10 November 1967 enhancing the circulation of securities. That Royal Decree in turn is at the origin of the Luxembourg regulation of 17 February 1971 concerning the circulation of securities which was adopted for the development of CEDEL, created in 1970, and of the financial market place of Luxembourg in general.

These Belgian and Luxembourg texts introduce an element of dematerialisation. The progress realised is double: 1) the obligation to make a physical delivery is replaced with an obligation to make a book-entry delivery; and 2) the obligation for the depository to re-deliver exactly the same securities disappears and is replaced with an obligation for the depository the re-deliver the same amount of equivalent fungible securities of the same issue.

The ability to transfer securities in book-entry form has been the basis for the simplification of the flow of securities across borders through the development of global custody networks, international central securities depositories (ICSDs) and links between national central securities depositories (CSDs). The availability of book-entry settlements makes it possible for CSDs, ICSDs and custodians to offer comparable settlement services in a wide range of national markets.

Full dematerialisation (no deposit of paper securities neither of certificates confirming book-entries) has only been achieved in most Member States in the course of this decade.

Most government debt of the Member States is now issued and traded in book-entry form. The investor must rely exclusively on bookkeeping records to identify its interest in such securities. In a typical transaction, there are a number of intermediaries between the investor and the issuer. The government issuer keeps one set of records which establishes the entire amount of the securities outstanding and the entity to which the government issuer will make payment – the record owner of the debt. In most countries this is a CSD which identifies the amount of the issue held on behalf of each of its direct participants. Those direct participants will often include ICSDs, local agents of global custodians, and CSDs operated in different countries. Each of these entries provides clearing and custody services to other institutions, including ultimate investors and other custodians.

Although the resulting legal relationships may not always be clear, the tiering of relationships is, in many respects, necessary to complete securities transactions in modern markets. Paper-based

settlement of securities is increasingly rare; it is inefficient for high-volume markets. The 1989 recommendation of the Group of Thirty to shorten settlement cycles to three days has increased pressure to eliminate paper from securities trades. All of these factors have spurred the development of mechanisms that avoid physical delivery of paper securities in the settlement of trades.

Recent developments in the market such as Straight Through Processing (STP) and, even more, Real-Time Gross Settlement (RTGS) of securities also have the potential of entailing over time a more systematic and generalised dematerialisation of securities.

In the framework of the G-10 a "Committee on payment and settlement systems" was created which submitted in 1992 and in 1995 two reports on the settlement of securities. These reports attempt to identify the systemic risks inherent in the existing methods of securities settlements. One of the risks that was identified is the risk of the default of the subdepositary. Another risk is related to the physical transfer of securities between, for example, the sub-depositories of two different securities settlement systems (although in the meantime such physical transfers between subdepositaries are in all likelihood replaced with book-entry realignments). In case one or both of these two risks were to materialise there would be a possibility for a wide-spread disturbance of the securities markets.

In a market of dematerialised securities, such risks are non-existent, which seems to warrant support for a more generalised dematerialisation of securities.

III. Legal status of securities

The legal framework for the multi-tiered holding of securities falls into one of two general types: one applies the conventional legal framework for securities to book-entry systems by presuming the existence of physical securities; the other builds a new legal framework for "dematerialised" securities that are issued solely in electronic form.

The first type of arrangement relies on a legal fiction to fit book-entry securities into a paper-based legal theory. The law pretends that the securities exist in physical form. Ownership rights and the transfer and pledging of book-entry securities are then explained in terms of "possession" and "delivery" through the mechanisms of "immobilisation" or "global certificates", in which physical securities are deemed to be deposited and kept in fungible form. An investor shown on the books of the intermediary is regarded as having "physical possession" of the respective securities and, as a consequence, acquires a "property interest" in them. The completion of book entries is deemed to have the same effect as physical delivery of the relevant securities.

A legal arrangement created for dematerialised securities may take several approaches. The most common approach in the Member States seems to be where the fungible nature of book-entry securities is explicitly recognised, leading to a new characterization of the investor's property interest. The investor may be treated as a co-owner of all the securities of the type it has purchased that are held by the intermediary. The investor then retains a specific property interest in the securities but can only claim it on a proportional basis.

The remaining variation among Member States in their legal treatment of securities raises significant issues for cross-border securities transactions. Problems may arise in a number of typical transactions. For example, dematerialised securities issued in one country may be handled in the book-entry system of a second country that relies on an immobilisation scheme and the legal fiction of possession. In that case, it may be unclear whether the dematerialised securities qualify as securities in the second country. If they do not, the transferee of the dematerialised security may acquire a legal interest which is significantly different from the one it expected.