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RESPONSES OF THE AFME POST TRADE LEGAL COMMITTEE WITH THE AFME PRIME BROKERAGE COMMITTEE AND THE AFME SHADOW BANKING WORKING GROUP TO QUESTIONS RAISED BY HMT ON RE-HYPOTHECATION AND OTHER TOPICS OF SECURITIES LAW LEGISLATION (SLL)

1. *What were the main issues and lessons learnt from the failure of Bear Stearns, Lehmans, and MF Global in terms of client asset protection issues and the return of client securities?*

   The underlying causes of – and consequent lessons to be learnt from - the failure of each of these firms are different from those of the others. Moreover, the circumstances and causes of these failures are wide-ranging and far beyond the scope of the highly specific intersection of securities law and property law. Whilst it would not serve in the interest of securities law reform to speculate on the contribution to the financial crisis of these widely varying factors – ranging from macro-prudential policy objectives to internal systems and controls problems – what can be said with certainty is that the lack of a global, harmonised system for registering and recognising intermediated interests in financial instruments was not the cause, nor a contributing factor, of financial institution failures, any more than it was for Northern Rock, RBS, Lloyds, Dexia, Carnegie, Parex, HQ Bank or any of the other firms which required state intervention to continue in business or have been resolved during the global economic crisis. A statementwhereas "cross-border uncertainty over 'who owns what' complicated and contributed to the financial crisis and continues to do so today," is simply not supported by any available evidence.

   The three firms identified in the were all based in the United States; but there is no evidence that the United States lacks an appropriate system for the identification and registration of interests in financial instruments. Indeed, even if one focuses exclusively on the United States, it is quickly evident that insolvencies of intermediaries – including very large commercial and investment banks – has happened with regularity in recent decades without undue disruption to identification and preservation of ownership interests in financial instruments held for customers and without undue delay in returning those financial instruments on customers' request.

   We believe the situation in the United States, including in relation to the actual impact on the clients of the three identified firms, should be characterised differently . For example, on 5 October 2012, it was announced that all customer property claimed in relation to Lehman Brothers Inc. is expected to be returned:

   > "About $38 billion in claims relating to the Lehman Brothers Inc. (LBI) liquidation proceeding will be resolved and the way paved for a 100 percent return of customer property if the agreement in principle reached today by James W. Giddens, Trustee for the liquidation of LBI under the Securities Investor Protection Act (SIPA), and Tony Lomas, the Joint Administrator of Lehman Brothers International (Europe) (LBIE) is approved by the Court."[1]

[1] http://www.sipc.org/Media/NewsReleases/Release20121005.aspx

Bear Stearns was not resolved; it was purchased by J.P. Morgan in 2008, after the failure of two Bear Stearns-sponsored hedge funds led to a credit contraction impacting the firm's liquidity. The transaction was initiated by US authorities, precisely to mitigate the potential impacts to firm customers and the wider financial system. There is no indication that clients of Bear Stearns failed to receive any of their property in accordance with their rights; nor that there was any controversy over ownership of assets at Bear Stearns as a result of a need to determine "who owns what."

Media reports on MF Global indicate that there were issues with the firm's internal record-keeping (as there appear to have been at Lehman Brothers). The existence of a harmonised system of recognising and registering interests in intermediated securities can never substitute for the proper implementation of systems and controls within a firm, and the question must be how supervision can be made more effective to ensure that proper internal records are being kept. We think this is the primary lesson to be learnt from both the MF Global and Lehman Brothers failures.

For more background on the law applicable to the three failures referenced in the Discussion Paper and comparative aspects of other relevant law, please refer to Annex I. The key conclusion to be drawn is that both U.S. law and civil law systems alike in fact confer *in rem* rights in dematerialised securities (in the form of property rights in a fungible pool of securities) but – in both systems, some dependence on the performance of intermediaries is unavoidable. This ***also*** creates – in civil law and common law systems alike – the potential for *in personam* claims (personal claims) against such intermediaries. In other words, as Prof. Matthias Haentjens has written: ". . . a strict distinction between contract law and property law is virtually impossible to maintain, i.e., that contract law and property law are intrinsically intertwined, so that one cannot exist without the other."[2] This holds true equally – but for very different reasons - under the national laws of The Netherlands, France, Belgium and the United States, among others.[3]

2. *What measures could be put in place to address the lessons learned from the failure of Bear Stearns, Lehmans, and MF Global and to improve the protection of client securities?*

In the UK, a number of measures have already been introduced to tackle some of the concerns arising from the Lehman administration. In terms of the role of the administrator, the Investment Bank Special Administration Regulations 2011 introduced a statutory requirement for investment bank administrators to ensure the return of client assets as soon as reasonably practicable (alongside other objectives to ensure timely engagement with market infrastructure bodies, and to either rescue the bank as a going concern or wind it up in the best interests of creditors). Under the revised Administration Regulations, the administrator has the ability to prioritise the object of returning client assets, if it deems this appropriate. As compared to the insolvency regime which governed the administration of Lehman Brokers International Europe, this can be

[2] *M. Haentjens*, Between Property Law and Contract Law: the Case of Securities, The Future of Property Law, Sellier European Law Publishers, *edited by Sjef van Erp, Arthur Salomons and Bram Akkermans*, 2007, pp. 165-166.
[3] Id., pp. 170-172.

regarded as a significant improvement in terms of client asset protection, as there is now specific recognition of the objective of return of client assets, allowing the administrator to prioritise this in the context of the overall administration.

Further improvements have been made under the FSA's client asset rules (specifically Chapter 9 of the client asset rulebook, setting out rules applicable to prime brokers). These rules mandate daily reporting by prime brokers to clients, including reports on the current value of client assets and client money held, loans advanced, borrowed securities due back from a client and short sale proceeds held, value of OTC and listed derivative positions, total secured obligations, collateral held and the details of any re-hypothecated securities and details as to the location of any client assets. These reports improve the visibility of clients as regards the location of their assets, the value of their outstanding liabilities (in relation to which such assets constitute collateral) and which assets have been re-hypothecated: these improvements have been introduced as a direct response to concerns arising from the Lehman administration.

In addition to mandated reporting, the FSA client asset rules require prime brokers to include a specific annex to each prime brokerage agreement, describing for the relevant client the location of the relevant terms of the agreement governing the right of re-hypothecation, a description of the contractual limit on re-hypothecation, and a description of certain risks arising from re-hypothecation. These requirements were introduced to ensure that clients understand the nature of re-hypothecation and the right of the prime broker to re-hypothecate assets.

The introduction of mandatory resolution planning, requiring the preparation of Recovery and Resolutions Plans (including a specific client asset module for firms holding client assets) by relevant firms, should also assist a timely return of client assets: new consultations under way are expected to ensure that necessary planning, other steps and records are put in place and maintained in order to protect customers' assets.[4]

As noted above, there is no clear link between the very different situations that developed at the three firms identified and the need for a harmonised book-entry system for intermediated securities. Despite this, AFME has long recognised the benefits that greater harmonisation of securities holdings and dispositions could bring to Europe, including buyers, sellers and owners of securities. AFME have made a number of contributions over the years in furtherance of efforts to achieve harmonisation that improves investor protection and certainty of settlement whilst reducing cost and cross-border barriers to entry. We recognise that there are obstacles to an efficient market within the European Union, and on a global basis, arising from differing securities, property, company and insolvency laws in different countries, and support the work to address them. The European Union has long sought to identify and address these challenges - beginning in January 2001 under the auspices of the Giovannini Group[5].

[4] *See, e.g., Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks*, European Commission, 5th October 2012, as well as the European Commission's adoption of a legislative proposal for an *EU Framework for Bank Recovery and Resolution*, June, 2012.

[5] The Giovannini Group was composed of financial-sector experts - meeting under the chairmanship of Alberto Giovannini - to advise the European Commission on financial-sector issues. The work of the Group on clearing

Since then, very significant progress – involving legal and other experts from throughout Europe – has been made towards resolving these challenges.[6] It would be very disappointing if this essential work is relegated to irrelevance solely on the basis that it was based on a legal perspective developed before the crisis in 2008 It would also be disappointing if any new work was to be rushed unduly so that efforts to achieve harmonisation were made on an administrative basis, rather than through thoughtful and incremental reform.

3. *What are the current arrangements between clients and intermediaries as regards the re-hypothecation and re-use of client securities?*

The primary purpose of re-hypothecation is to generate and reduce the cost of financing for the borrowing and other trading activity of the party who grants another party (for example, a prime broker) the right to re-hypothecate its assets. The prime brokerage relationship is the most obvious example of the use of re-hypothecation for this purpose.

Re-hypothecation should not be confused with the process that prime brokers use for collateralising their exposure to their clients. Prime brokers rely on a security interest over assets they hold on behalf of the relevant client to protect them from a client default (allowing the prime broker to liquidate assets and apply liquidation proceeds against any exposure to the defaulting client). Re-hypothecated assets would be factored into a close-out calculation following a client default, enabling the prime broker to set off the value of re-hypothecated assets it owes back to the defaulting client against amounts owed by that client, and in this sense re-hypothecation may be seen as a credit risk mitigant. However, this post-default remedy does not "cause" a prime broker to re-hypothecate assets - the purpose of such re-hypothecation is as stated above.

It is very important to clarify what is meant by the terms "re-hypothecation" and "re-use".

Re-hypothecation should be regarded more narrowly than "right of use" of collateral assets, as that term is defined in the Collateral Directive. This is consistent with the application of "re-hypothecation" and "right of use" within the prime brokerage model and is consistent with the definitional and policy-making framework being pursued by the Financial Stability Board.[7] The intention is to refer to the practice of using collateral assets which are subject to a security interest (and which, prior to any re-hypothecation, are owned by the collateral provider), so that ***once re-hypothecated*** the relevant assets may be disposed of by the re-hypothecating party. A fundamental part of this definition is that, prior to exercise of the right of re-hypothecation, ownership of the relevant assets is retained by the collateral provider. In other words, re-hypothecating customer assets may be considered an exercise of the right of use.

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and settlement was expected to inform Commission policy and responded to a mandate received from Commissioners Solbes and Bolkestein.

[6] A more detailed description of this progress is set out below in the response to Question 11.

[7] Financial Stability Board, Consultative Document, Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Section 3.3, pp. 22-23.

This should be contrasted with a title transfer collateral arrangement, where from a legal perspective re-hypothecation is irrelevant. Here, the collateral provider transfers full legal and beneficial interest in the collateral to the collateral taker. In this regard, the collateral provider no longer has any rights in relation to the actual assets constituting the collateral. Instead, it has a contractual claim for return of equivalent assets, but this does not constitute any legal right to the actual collateral assets. As the owner of the collateral, the collateral taker can now use the collateral however it wishes (in doing so, it is not re-hypothcating or re-using *client* assets, as it actually owns the collateral). If it wishes to transfer the collateral onward to a third party, or grant a security interest over it in favour of a third party, it may do so as owner of the collateral asset. It does not need to be granted further rights from the collateral provider to do these things.

It is therefore inappropriate to regard the onward use of title transfer collateral as the exercise of a right of re-hypothecation or right of use. To label it as re-hypothecation or right of use is also problematic from a legal perspective, as it is inconsistent with the legal basis on which a collateral provider has transferred title to the collateral taker. Conflating these two concepts risks engendering uncertainty as to the legal capacity and authority of a collateral provider, which in turn would create legal (and thus credit) risk for the collateral taker. This result would be highly counterproductive in view of the overriding goal since the advent of the financial crisis of increasing legal certainty for transacting parties and reducing systemic risk.[8]

Re-hypothecation should also be contrasted with what might sometimes occur in the context of securities settlement involving omnibus accounts. Omnibus accounts operate on the basis that book-entry (dematerialised) securities are held in fungible bulk for the benefit of account holders collectively. These structures are used throughout the custody industry and not just by prime brokers. Where a customer (as account holder) purchases a security and then sells the same security, but settlement of its purchase transaction is delayed, it is possible that the fungible bulk could be drawn on to facilitate settlement of the sale (since the purchased security is not available yet for delivery). This facility is available in omnibus account structures – with informed, written consent of customers - in order to ensure timely settlement as and when expected, whether or not the account provider is a prime broker and whether or not a client has granted a right of re-hypothecation. Ensuring settlement in this manner should not be regarded as involving "re-hypothecation" since the obligation of the customer's counterparty to deliver a purchased security on settlement date remains – unconditionally – in place, as does the interest of each customer on a pro rata basis in the pool. A key prudential consideration underpinning securities settlement is that it is the selling counterparty to a transaction who is principally obliged to deliver the security (as property) to the purchaser, and not the intermediary custodian.

4. *Are you aware of re-hypothecation or re-use arrangements (or any other arrangements) causing securities inflation or uncertainties concerning client/intermediaries/CCPs rights to securities? To what extent are securities re-hypothecated or re-used down a lengthy holding chain?*

[8] The consequences for onward delivery of a financial asset that has been rehypothecated is discussed in more detail in the response to Question 4, below.

Re-hypothecation does not cause any legal uncertainty as regards "who owns what", nor does it create any securities inflation or competing claims over assets. As a legal concept, re-hypothecation is simple and commonly understood, and is enshrined in European legislation under the Collateral Directive.

When a prime broker re-hypothecates an asset, it becomes the legal and beneficial owner of that asset. At that point the client ceases to have a beneficial interest in the asset, but continues to have a contractual claim against the prime broker for redelivery of an equivalent asset. As owner of the asset, the prime broker is now able to deal with it, which may include transferring title onward to a third party, or granting a security interest over the asset in favour of a third party. These onward uses of the asset do not detract from the core underlying legal principle that the client no longer owns the asset, but has a contractual claim against the prime broker for redelivery.

Any prime brokerage agreement should be clear as to the legal effect of the granting and exercising of any right of re-hypothecation. Provided that this is the case, and that the prime broker's records and operational systems (including underlying account records) accurately reflect which assets have been used and how they have been used, there should be no uncertainty as to the legal position of the client and the prime broker in relation to any re-hypothecated assets.

Similarly, the onward use of title transfer collateral does not cause any securities inflation or competing claims over assets. When a collateral provider transfers collateral to a collateral receiver under a title transfer collateral arrangement, the collateral provider ceases to have any ownership interest in that collateral, and instead has a claim against the collateral receiver for redelivery of equivalent securities. The nature of this claim is the same as the claim a client has against a prime broker for redelivery of a re-hypothecated asset. As with re-hypothecation, any onward use of title transfer collateral does not detract from the core underlying legal principle that the collateral provider no longer owns the asset, but instead has a contractual claim against the collateral receiver for redelivery. There is no "inflation" of securities since delivery of the asset – which will be reflected in a(n) (I)CSD or across the books of a custodian – corresponds to the extinction of the collateral-giver's interest in favour of the collateral-taker.

The onward use of re-hypothecated assets or title transfer collateral down a chain of intermediaries does not change the legal relationship between the party granting the right of re-hypothecation and the party exercising that right (in the case of re-hypothecation) or the collateral provider and the collateral receiver (in the case of title transfer collateral). In relation to re-hypothecated assets and title transfer collateral, the position of the asset provider is equivalent – it has a claim for redelivery of equivalent assets, but has no ownership interest in the underlying asset. In that sense, it is not relevant how the underlying asset is then used, and which intermediaries the asset passes between.

Any discussion as to the jurisdictional variations/uncertainties in securities and insolvency laws should not focus on re-hypothecation, as re-hypothecation itself is irrelevant in this regard. As with title transfer collateral arrangements, provided that all relevant account entries accurately reflect the relevant transfer of assets, and the respective claims and obligations of the parties, there should be no instance of securities inflation or uncertainty as to who owns what.

5. *To what extent (if any) are pledged securities (pledging on pledging) being re-hypothecated and re-used? If so, why are these arrangements used and what risks do they raise?*

As mentioned above, under a prime brokerage relationship, prior to exercising a right of re-hypothecation in relation to a particular asset, the asset will be owned by the client but subject to a security interest in favour of the prime broker. In this sense, the securities are "pledged securities"[9], i.e., secured in favour of the prime broker but still owned by the client. Most commonly, a prime broker will exercise a right of re-hypothecation by transferring the underlying asset from a client account to a firm account (or to the account of a third party). In so doing, the client ceases to have any ownership interest in the asset, and as such the asset itself is no longer subject to the security interest. The prime broker will then use the asset, for example as collateral under a separate repo or securities lending transaction, in order to secure a source of cash or securities for prime brokerage clients. It will be necessary for the prime broker to own the underlying asset in order to use it in this way, as collateral provided under market standard repo or securities lending transactions must be owned by the collateral provider before it is provided to the collateral receiver (title transferring from provider to receiver).

The above makes it clear that a prime broker or other intermediary does not "use" a client asset – as no client interest subsists - by granting a security interest over it when it is still owned by the underlying client (the "pledge on pledge" scenario referenced in the question). In any case, a repo or securities lending counterparty of the prime broker would not accept such an arrangement as it would wish to be transferred title in the underlying collateral asset.

It must be re-emphasised that not all intermediaries holding securities accounts have a capacity or interest in "re-use" or "re-hypothecating" client assets. Such activities must be explicitly authorised under the terms of customer documents and many intermediaries (e.g., custodians not seeking to use customer securities in their own business) do not seek such authorisation. There is no possibility of "re-use" of customer assets arising merely by dint of a grant of a security interest. Indeed, such actions would significantly undermine and contradict the law on security interests. The purpose of "pledging" collateral is to secure obligations of the collateral-provider to the collateral-taker. The latter may only have access to this collateral for its own use upon default by the former and the satisfaction of certain requisites in the exercise of the collateral-taker's rights and remedies.

6. *What are client and intermediary views on preventing or limiting the re-hypothecation and re-use of client securities?*

Please see the response to Question 7 below.

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[9] Legally speaking, under English law the term "pledge" is not an accurate description of the nature of the security interest, as this is an English law *charge* over dematerialised assets (as opposed to a pledge, which would be used for tangible property). Nevertheless, the terms pledge is often used in reference to a charge granted over dematerialised assets.

7. *What would be the impact if re-hypothecation and re-use of client securities was prevented or limited (such as on market liquidity and collateral availability)?*

As regards limiting a right of re-hypothecation, prime brokers could be required to offer their clients a re-hypothecation cap. However, such caps are already a standard client offering by prime brokers, and the vast majority of clients will require a cap to be negotiated into the prime brokerage agreement. Re- hypothecation caps are typically expressed as a percentage of the client's liabilities to the prime broker. These are negotiated with clients on an individualised basis, and take account of the client's funding requirements and its portfolio of assets, so that both the percentage cap and the constituent elements of the cap (e.g. the types of liabilities owed by the client) can be tailored to the client's portfolio. In some cases, a client's portfolio could be funded with a lower cap than the industry average. Conversely, in some cases a higher cap may be necessary, as the portfolio of assets available for funding is less liquid, and the prime broker will need to be able to use more assets in order to generate the client's required level of funding. For this reason, we think it would be inappropriate and counterproductive to prescribe a "one-size-fits-all" industry-wide standard cap.

As mentioned above, re-hypothecation brings an economic benefit to the party granting that right. The right of re-hypothecation is granted over a changing pool of assets, and in this regard the practical application of re-hypothecation by the prime broker is to the client's benefit. The prime broker will be able to select which assets to re-hypothecate in order to generate the requisite funding for the client. This will be subject to whatever re-hypothecation cap may be agreed with the client, and the prime broker can take account of any request by the client to restrict re-hypothecation of particular assets (for example, to enable the client to participate in a corporate action).

The client understands the economic benefit of granting the right of re-hypothecation, and limits its exposure to the prime broker through any cap it agrees. It can also monitor which assets have actually been re-hypothecated, by receiving re-hypothecation reports from the prime broker (as now required pursuant to UK rules). However, prime brokerage clients do not wish or need to be actively involved in approving re-hypothecation or transferring title in assets to a prime broker on an asset-by-asset basis. This is not operationally feasible, nor is it necessary – especially in light of significant enhancements already implemented, such as the required provision of re-hypothecation reports and improved disclosures of customer positions. It is both the funding benefit and the operational simplicity of re-hypothecation that is attractive to prime brokerage clients.

For the prime brokerage model, a title transfer collateral arrangement is not a suitable substitute for re-hypothecation. Firstly, as mentioned above, re-hypothecation is driven by the need to obtain funding for the client, and not by the need to collateralise exposure to the client. Secondly, a title transfer collateral arrangement typically requires the collateral provider to monitor its ongoing collateral requirements, and to post additional collateral on a day-to-day basis. Prime brokerage clients are not in a position to perform an active collateral management function. If they relied on the prime broker for this, title transfer collateral would be the same process as re-hypothecation, and the client's legal and risk position as regards the prime broker would be the same.

The prime brokerage industry has very deliberately adopted the re-hypothecation model to best suit its clients. The structure minimises credit exposure for the client (which would occur to a greater extent if all assets were provided under a title transfer collateral arrangement), affords the client operational simplicity, accommodates client corporate action requests, and allows for the funding of a dynamic investment portfolio. The nature and effect of re-hypothecation is also well understood by prime brokerage clients, who are all professional investors.

It is true that a prime brokerage client is a creditor of the prime broker in relation to re-hypothecated assets. However, this position is the same as that of a collateral provider under a title transfer collateral arrangement: both re-hypothecated assets and assets that have transferred under a title transfer collateral arrangement are subject to right of set off. If a prime broker becomes insolvent, this should constitute an event of default allowing the client to serve a close-out notice, and set off the value of obligations it owes the prime broker (e.g., to repay borrowed money and return borrowed securities) against the value of the prime broker's obligation to return re-hypothecated securities. As such, a prime brokerage client should not be regarded as an unsecured creditor for the gross value of re-hypothecated securities; rather, it can reduce any such exposure through its right of set off.[10] In principle, this is the same position as a securities borrower under a securities lending agreement, or a repo borrower (i.e., seller) under a repo agreement.

As also noted in the response to Question 5 above, there appears to be some confusion about the relationship between rights of re-use and security interest collateral arrangements; and, in particular, the incorrect assumption that the latter leads to the former. One reason why this incorrect assumption is potentially damaging is because many collateral-takers rely on collateral for reasons having nothing to do with right of use. Bank custodians, for example, take security interests in customer securities for the simple purpose of securing exposure that may arise in cases of settlement failures (particularly when sale proceeds do not arrive) and the customer requires funding to settle other transactions. Bank custodians do not have rights of re-use over customer securities for this purpose, nor have they sought to obtain them.[11]

8. The premise that security interest collateral arrangements always involve rights of re-use, is inaccurate. It is therefore incorrect to say that security interest collateral arrangements result in re-use and represent a cause of so-called “unresolved challenges of collateral-based systems”. It is also inaccurate to state that, where a right of use/re-hypothecation is included under a security interest.*What would be the impact of a broad ‘no credit without debit rule’? What specific arrangements/transactions might such a rule impact on?*

[10] This approach is recognised under the Financial Collateral Directive. If a firm is certain that it can rapidly close-out successfully transactions with its counterparties in case of their insolvency (i.e. the applicable insolvency law will not prevent close-out), its counterparty credit risk is substantially reduced to the resulting net position. This is translated into (a) substantially reduced capital charges, and (b) a reduction in the collateral which might be provided to secure the resulting net positions. This has made netting an important risk mitigation technique. Financial institutions and other "corporate entities" widely rely on contractually agreed netting arrangements to achieve this result in the EU and elsewhere.

[11] It should be noted that requirements relating to any right of use is specifically addressed under UK Rules – relating to prime brokers and not other kinds of custodians – in CASS 9 in the FSA Handbook.

We understand a "no credit, no debit" rule to refer to a process whereby the top account (in the case of a prime brokerage relationship, the account on the prime broker's books and records reflecting the assets of the client) will be updated to reflect any assets re-hypothecated from that account, to ensure that there is a debit on that account to reflect any credit on a prime broker's own firm account, or that of a third party, as an asset is re-hypothecated. As mentioned above, FSA-authorised prime brokers are already required to provide daily reporting to clients specifying which assets have been re-hypothecated. It is the case that many prime brokerage clients prefer to see this as a separate report, so that the main prime brokerage account report will include custody assets along with re-hypothecated assets, and the client can review the separate re-hypothecation report to determine which assets have been re-hypothecated. The reason why clients may prefer this is that the aggregated report, showing both custody and re-hypothecated assets, enables the client more easily to calculate the net asset value of the fund (where the client is a hedge fund, for example).

Custodians who do not provide prime brokerage services typically still maintain records of securities that have been lent under securities lending arrangements or subjected to other transactions such as repo. Again, this is to provide a "valuation" report but not to indicate the assets are actually held "in custody". In these cases, the securities are clearly marked as unavailable since they have been dispensed with, subject to return pursuant to the particulars of the transactions to which they have been subjected.

9. *What are the links to other EU legislation concerning the holding of client securities and the re-hypothecation and re-use of client securities (such as UCITS and AIFMD).*

<u>Alternative Investment Fund Managers Directive</u>

With respect to the AIFMD, there are several references in the legislation to "re-use", which for this purpose means re-hypothecation of client securities. A number of provisions within the AIFMD focus on the prime brokerage relationship, and the potential for an AIF to obtain leverage from a prime broker and grant a right of re-hypothecation.

Article 14(3) refers to the prime brokerage agreement and requires that, "any possibility of transfer and reuse of AIF assets shall be provided for in that contract and shall comply with the AIF rules or instruments of incorporation. The contract shall provide that the depositary be informed of the contract."

Article 15(4) contemplates limitations on the right of re-hypothecation in the context of the risk management function of the AIFM.

As regards the depositary of an AIF, Article 21(10) provides that assets in custody "shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF." Article 21(11)(d)(iv) requires the depositary to ensure that a custody delegate (which means a subcustodian, such as a prime broker to whom custody tasks have been delegated by the depositary) "does not make use of the assets [of an AIF] without the prior consent of the AIF or the AIFM acting on behalf of the AIF and prior notification to the depositary".

There is also recognition in Level 2 implementing rules that re-hypothecated assets are not regarded as assets held in custody by the depositary.

The essence of these requirements is to prevent the assets of an AIF from being re-hypothecated without consent having been given by the AIF (or the AIFM acting on behalf of the AIF) through contract. In practice, prime brokerage agreements do provide for such consents, and there are sound controls used by all leading prime brokers to measure the extent of re-hypothecation and rapidly identify and correct on a daily basis any use of assets beyond pre-agreed limits. The limits which are applied are also agreed with and documented for each client by the prime broker.

Collateral Directive

The EU Collateral Directive includes specific provisions (under Article 5) acknowledging that a right of use (i.e. re-hypothecation) arrangement may exist under a security financial collateral arrangement, and setting out the legal effect of such arrangements. This gives the basis for a pan-European recognition of the legal basis of those arrangements.

MiFID, MiFID II, EMIR

The Markets in Financial Instruments Directive (MiFID) prohibits a MiFID firm's ability to "use" a client's financial instruments without the clients express consent.[12] MiFID II is expected to prohibit title transfer arrangements relating to assets of "retail" customers.[13] It should be noted that the European Market Infrastructure Regulation (EMIR) requires that when a client opts for individual client segregation through the clearing chain at a CCP, any excess margin over and above the client's requirement should also be posted to the CCP and distinguished from other clients' or clearing members' margins and should not be exposed to losses connected to positions recorded in another account. EMIR does, however, permit a CCP to use/re-hypothecate margin or default fund contributions it has collected by way of a security financial collateral arrangement. A CCP must publicly disclose this right of use/rehypothecation.

The Relevance of Close-out Netting and Associated Directives

As mentioned above, re-hypothecated and re-used assets may be used to offset obligations of counterparties under close-out netting or set-off arrangements. Close-out netting and set-off (henceforth 'close-out netting') are legal mechanisms, available under all Member State laws but with diverging scope and conditions, that reduce exposures and therefore risks between two counterparties. Close-out netting may be available in normal and/or in insolvency situations. It may be contractually agreed and permitted by national law, or imposed directly by law. Close-out netting must be effective under national insolvency laws. The financial crisis has put close-out netting and set-off arrangements in the spotlight due to their relevance to the forthcoming EU framework for crisis

[12] Article 13(7) of Directive 2004/39/EC. See also Articles 16(2), 17 and 19 of Directive 2006/73/EC (the "MiFID Implementing Directive")
[13] The UK FSA has written, "Our expectation is that MiFID will prohibit all forms of absolute title transfer for retail clients." *See,* FSA CP 12/22 Client assets regime: EMIR, multiple pools and the wider review, Part III, September 2012, footnote 26, p. 42.

management in the financial sector.[14] To this end, the consistency and adequacy of relevant EU legal measures (notably the Insolvency Regulation, the Bank Winding-Up Directive, the Financial Collateral Directive and the Settlement Finality Directive) are all to be examined and, where appropriate, amendments will be proposed. In addition, the Basel
Cross-border Bank Resolution Group's recommended in its March 2010 report that jurisdictions should promote techniques such as netting in order to reduce systemic risk; but that such risk mitigation techniques should not hamper the effective implementation of resolution measures.

10. *What are your views on the Commission looking for arrangements that allow segregation of client assets such as segregated accounts from the end-investor to the top of the holding chain?*

Segregation throughout the entire chain of custody is simply not possible in every market, because of restrictions in certain markets. It is also not a practical arrangement, since the use of omnibus accounts reduces both costs to end investors and the risks of operational errors.

It should be kept in mind that the primary risk to be avoided is compromising customers' ownership interests in and access to their securities due to the insolvency of their account providers and other intermediaries in the holding chain. To this end, from an English-law perspective:

- Securities entrusted to a custodian for safekeeping are kept off of the balance sheet of the custodian. The segregation of securities ensures that they will not form part of the estate of the custodian, should it require resolution. This segregation will apply whether client assets are held in a client-specific account, or in a comingled (omnibus) client account: in both cases they would be segregated from the custodian's own assets upon an administration/insolvency.

- The role of a custodian, in relation to securities, is in its essence that of an agent/bare trustee.[15] The securities entrusted to the custodian belong to its principal, which has (a) contracted to purchase them, (b) paid for them (assuming that the credit of the custodian has not been drawn upon to finance the acquisition), and (c) entrusted them to the custodian for safekeeping without transfer or delivery to the custodian of any property rights. The principal has the right to call for the return of its securities, and the custodian, as its agent, is obligated to deliver them, unless it has a right to retain them (for example, because the principal has outstanding obligations to it) or it is unable to do so (for example, because of governmental action in a particular market).

Use of omnibus accounts do not prejudice customers' interests so long as intermediaries' perform their functions properly by allocating customer positions accordingly in their custody records. This truism would equally apply where no omnibus accounts are used.

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[14] See, Communication 'An EU Framework for Crisis Management in the Financial Sector' COM (2010) 579 final

[15] The characterisation of the custodian's role under English law is discussed in more detail in the response to Question 13.

In other words, prohibiting the use of omnibus accounts cannot substitute for questionable practices or poor record-keeping. This is especially important to consider since, if anything, the mandatory segregation of customer positions throughout the holding chain would significantly increase operational and structural complexity, which in turn would increase the risk of mismatches and error.

The debate about imposing segregation ***among customers*** (account holders) through the entire holding chain has mainly derived from a presumption that issuers of securities want or need to know who their beneficial owners are rather than from some imperative to further enhance customer protection.[16] Whatever the motivation, the utility of segregated positions throughout the chain has been comprehensively rejected, most recently as reflected in the Report of the Task Force on Adaption to Cross-CSD Settlement in T2S (TFAX)[17] (the "TFAX Report"). The previously issued Final Report of the T2S Taskforce on Shareholder Transparency set out a framework for sensible alternatives for ensuring sufficient transparency for issuers going forward.[18] The key conclusions and considerations in both of these reports are set out in more detail in Annex II.

Finally, even if mandatory segregation throughout the custody chain were operationally (and safely) feasible in the European Union, the imposition of a requirement to segregate beneficial ownership throughout the entire holding chain assumes a holding chain that is entirely subject to the jurisdictional control of the European Union, or which at least operates in a manner that is amenable to fulfilling such a requirement. This of course may not be the case in respect of securities held via chains extending outside the European Union. In such cases, the imposition of segregation requirements may be frustrated by the operation of law or market practice outside the European Union.

11. *What are your views on the Commission moving away from the previous functional approach to securities law legislation to a more radical approach towards harmonising securities law?*

It has long been recognized that certain problems resulting from fragmented and inconsistent legal systems manifest themselves most seriously when transactions affecting the holding or disposition of securities (e.g., clearing, settlement and transactions deriving therefrom, such as corporate actions and the granting or exercise of security interests) cross national borders. The need for a harmonised pan-EU framework in respect of clearing and settlement of securities remains: Europe's diverse and fragmented national systems of clearing and settlement have long been recognised as inefficient, prone to error and relatively costly.[19] This has not changed. The work of the Giovannini Group[20] -

[16] Indeed, paragraphs 87 and 88 of the Discussion Paper suggest that one of the main purposes to be served by requiring "segregation" throughout the custody chain would be to achieve transparency for issuers (as stated above, we disagree that this is a sensible approach to ensure transparency). However, we recognise that the various Member States may each take different views as to whether other purposes are served through such segregation. Some states might instead emphasise perceived higher asset protection for investors: we maintain that segregation in itself in fact does not advance this goal, either, particularly in the cross-border setting.
[17] European Central Bank, T2S, *Report of the Task Force on Adaption to Cross-CSD Settlement in T2S*, 28 November 2012. The basis for the TFAX's rejection is set out in detail in the Report.
[18] http://www.ecb.int/paym/t2s/governance/ag/html/subtrans/index.en.html, 28th February 2011
[19] See Giovannini Group, *Cross-border Clearing and Settlement Arrangements in the European Union*, Economic Paper No.163 (February 2002), (the '2001 Report').

including its identification of '15 barriers' to effective cross-border clearing and settlement – remains no less relevant and valid today than it was prior the financial crisis.[21] The main conclusion of the Group's "2001 Report", that 'the EU financial market cannot be considered to be an integrated entity, but remains a juxtaposition of domestic markets',[22] is – if anything, more relevant than ever. In its Second Report (the '2003 Report'), the Group addressed the question of what actions should be undertaken to eliminate the problems identified in the 2001 Report. The main conclusion of this 2003 Report was that a concerted removal of the fifteen barriers identified in the first report was 'the essential ingredient to the reform of post-trading services in the EU'. There is no reason to abandon this conclusion in the wake of the financial crisis.

Of special relevance to any proposed Securities Law Legislation is the work of the Legal Certainty Group, which was established by the European Commission and commenced its work in 2005.[23] Significant and detailed analysis was undertaken and reports were issued by the Legal Certainty Group, which all remain entirely valid. Most recently, in 2008, the Group detailed the scope of the challenge of creating a coherent, sensible legal framework in respect of securities holdings and dispositions, pointing out that the need for such a framework had become paramount due to the 'sharp rise of the volumes of cross-border transactions in financial instruments'.[24] Referring to the previous Giovannini Reports, the Group explained in its Second Advice one of the key areas of its focus among the identified 'legal barriers':[25]

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

The Group emphasized as a priority the need for a harmonized legal framework within the EU that would comprehensively address the legal effects of book entries made to

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[20] The Giovannini Group was composed of financial-sector experts - meeting under the chairmanship of Alberto Giovannini - to advise the European Commission on financial-sector issues. The work of the Group on clearing and settlement was expected to inform Commission policy and responded to a mandate received from Commissioners Solbes and Bolkestein.

[21] As the Giovannini Group pointed out in its subsequent reports, there has been little or no dissent from the identification of these barriers since the issuance of the 2001 Report. Moreover, as the Group itself would later note in its 2003 Report (see *infra*), other bodies such as the G-30, CPSS-IOSCO, and ECB-CESR were either already active or about to become active on related issues. Each of these bodies had been highly productive in the intervening period, making important contributions to the ongoing debate on clearing and settlement at both the EU and global level. The Group duly took care to position itself vis-à-vis these other bodies so as to avoid duplication of work and to 'ensure consistency in any recommendations'.

[22] Giovannini Group, *Second Report on EU Clearing and Settlement Arrangements* Forward (April 2003), (the '2003 Report').

[23] See Legal Certainty Group, *EU Clearing and Settlement* - Synthesis Report of the meeting held on 31st January 2005, MARKT/G2/D (2005), March 2005. The Legal Certainty Group was an advisory group made up of thirty-six legal experts from the post-trading industry, legal practice, academia and competent authorities and a core secretariat provided by the EC. The Members were drawn from twenty-three EU Member States and participated in their personal capacity, representing neither their organizations nor their countries.

[24] Legal Certainty Group, *Second Advice on solutions to legal barriers related to post-trading within the EU* 9 (August 2008), (the 'Second Advice').

[25] *Ibid.*, 9-10.

securities accounts due to the fact that 'modern structures for securities holding and settlement of securities operate on the basis of services provided by account providers' and that credits and debits to securities accounts maintained by these account providers 'play a predominant role in practice throughout modern financial markets'. 'Therefore,' wrote the Group, 'it seems natural to take the securities account maintained by an account provider as a starting point for legal harmonization, prescribing that all acquisitions and dispositions effected through an account should have harmonized legal effects throughout the EU financial market.'[26]

Recommendations 1–11 of the Second Advice proposed a set of rules covering all legal aspects that need the Group believed needed to be addressed: the methods for acquisition and disposition; the minimum content of the acquired position; effectiveness and reversal; the protection of the acquirer; priority issues; the integrity of the number of securities; instructions; and the possibility of attachments (i.e., taking security interests on the relevant book entry securities).[27] The Group emphasized that the Second Advice recognized 'the diversity of legal concepts underlying securities holding and settlement throughout the Member States and that, '[c]onsequently, [the Second Advice] takes a functional approach of harmonization, as opposed to one attempting to harmonise fundamental legal concepts.'[28] Whilst achieving such a 'functional' solution has proved elusive, there is no reason why certain key elements of the approach could not be used to harmonising effect without undertaking the daunting task of harmonising national law regimes. If the EU is to achieve effective harmonisation in order to ensure investor protection on an equal, commonly understood basis without undue disruption and distraction, it will need to strike a pragmatic balance between achieving effective investor protection and interfering with varying legal concepts under respective national laws. It is most important to focus on cross-border holdings in this respect.

In 2011 (well after the financial crisis began), Philip Paech,[29] advising the EC's Directorate General for Internal Policies, Economic and Monetary Affairs,[30] expounded upon the challenge posed by cross-border holdings, describing it as one of the most difficult obstacles in overcoming the Giovannini Barrier of legal uncertainty.[31] Paech divided this challenge into three sub-groups:

- "The legal landscape of securities holding and disposition as well as of assisting investors in the exercise of their rights attached to their securities is fragmented.
- "The international nature of securities transactions leads to situations where the law of more than one country can influence the legal situation of securities holding. This is a consequence of the fragmentation of the law and widely acknowledged conflict-of-laws principles.
- "The existence of the legal uncertainty in this area is uncontested. However, Member States [*n.b.*, not to mention countries outside the EU] have an interest to defend their current domestic concept underlying securities holding and dispositions; therefore, the solutions envisaged deviate."[32]

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[26] *Ibid.*, 10.
[27] *Ibid.*
[28] *Ibid.*
[29] Professor, Department of Law, The London School of Economics and Political Science, formerly in the Financial Markets Directorate of the EC.
[30] P. Paech, *Cross-border issues of securities law: European efforts to support securities markets with a coherent legal framework*, prepared for the Directorate General for Internal Policies, Economic and Monetary Affairs (May 2011).
[31] *Ibid.*, 7.
[32] *Ibid*.

The debate among competing legal systems begins as soon as one tries to determine exactly what an intermediary purports to maintain as property on behalf of its customers. Paech found that the key inhibitors to achieving legal clarity – and clarifying legal obligations of intermediaries – associated with cross-jurisdictional (cross-border) holdings of securities are:

- The relevant conflict-of-laws rules lead to a situation where more than one country's law influence the legal status of the same underlying securities.
- There are five basic holding models for securities: the trust model, the entitlement model, the unshared property model, the pooled property model and the transparent model.
- The result is a sub-optimal legal framework for providing collateral over securities. Collateral is one of three major risk-mitigation tools (next to netting and segregation of client assets). It is used throughout the financial market, in particular also by Central Counterparties (CCPs).[33]

An unavoidable consequence of holding securities on a cross-border basis is that 'no intermediary can provide its account holder with a legal position that is better than the one it holds itself.'[34] And yet, as Paech pointed out:

> 'each applicable law determines autonomously the legal position in respect of the relevant securities, without taking into account the parts of the holding chain which are outside its reach.'[35]

We are of the view that all of the foregoing analysis is entirely valid and should not be discounted merely because some of it (and not even all of it) was undertaken prior the financial crisis. We submit this is a poor rationale for abandoning prior substantive progress.

We have suggested there is much prior work that could be put to harmonising effect sooner rather than later without undue disruption to national legal systems. We will provide further details setting out a proposed "operational approach" for effective harmonisation at a later stage.

12. *Are you aware of securities inflation issues or legal uncertainties raised in Member State's securities holding arrangements?*

We are not aware of any issues with securities inflation or legal uncertainties raised in Member States' securities holding arrangements. Securities inflation issues and legal uncertainties will arise if the books and records of counterparties and intermediaries, and the agreements setting out the legal arrangements between relevant parties, do not accurately reflect how securities are held and transferred.

13. *I would also like your views on the current UK trust law and fiduciary duties arrangements and how these protect clients assets and facilitate the exercising of client rights when they hold securities with account providers.*

[33] Paech, 13.
[34] *Ibid*., 24
[35] *Ibid*.

One of the strengths of the English legal system is that the rules of agency and equity have developed to protect the legitimate interests of beneficiaries when intermediaries with fiduciary responsibilities (whether agents or trustees) have been entrusted with the possession or control of property, which they are not entitled to treat as their own. An investor who holds securities with a custodian, under English law, is assured that they will be ring-fenced from the estate of the custodian in insolvency proceedings in the UK, and that the custodian cannot make use of such securities for its own account, except in such circumstances as the investor might freely agree. Under English law:

- A custodian is under specific duties towards each of its clients, as an agent towards each principal, to take care of the property of its principals and to account for it. English law regards the custodian as a "bare trustee", when considering the fiduciary element of its duties as agent towards each principal, which means that the English courts will act to enforce the claim of a principal in equity to overcome any legal estate which the custodian holds for the time being.

- The account records of the custodian are therefore key evidence of the entitlement of each of its clients to securities in its possession or control. The custodian's client has the ability (through contract and rules of agency, trusteeship and equity, which will be enforced by the English courts) to direct the delivery of the securities to which it is entitled. It is of no consequence that there is no security in a given market, which has been registered with a CSD as belonging to a particular client, if the client is able to rely upon the courts to compel the custodian to use its own powers (e.g., through its contract with its subcustodian or power to direct a nominee company) to deliver the relevant securities to another person of the client's choosing (e.g., a counterparty or a replacement custodian).

As pointed out by the Law Commission[36], the UK Model for protecting shareholders' rights in their securities is referred to as an "Indirect Enforcement System":

> In the United Kingdom, the holding of securities by way of book-entries in an intermediary's account is an example of an indirect enforcement system. Legal title to the securities is vested in the upper tier intermediary in whose name the securities are registered (in the case of registered securities) or in whose possession the securities are kept (in the case of bearer securities). The upper tier intermediary may typically be a CREST member holding the securities directly from the issuer through an account operated with CREST.
>
> The issuer may or may not have knowledge of whether the upper tier intermediary is holding the securities on behalf of others or for its own account[37] and is unlikely to know the identities of the intermediary's own account holders. The issuer's relationship is solely with the intermediary named on the register or in possession of bearer certificates.

[36] Law Commission Project on Intermediated Investment Securities, "Issues affecting Account holders and Intermediaries", 23 June 2006.

[37] In the case of equities, Companies Act 1985, s. 360 prohibits notice of any trust being entered on the register of members.

> Generally speaking, the upper tier intermediary will hold securities for its account holders on trust. Under English trust law, an account holder as beneficiary will not have the right to enforce the terms of the securities against the issuer directly.[38] The account holder's ability to receive the benefit of the terms of the trust assets (that is to say, the securities) is set out in the trust instrument (which will invariably be the account agreement). The trust instrument will ordinarily require the intermediary to collect and distribute to its account holders the economic benefits that it receives such as dividends or interest. It may also, but not always, require the intermediary to exercise voting and other discretionary rights in accordance with the express wishes of the account holder.
>
> In the absence of express provisions in a trust instrument, the account holder must rely upon the general fiduciary duties owed to it by the intermediary. Outside of its obligations to act in accordance with the trust instrument, a trustee must safeguard the trust assets, avoid conflicts of interest or unauthorised profits[39] and act with reasonable care and impartiality between beneficiaries. If necessary, the account holder can apply to the courts to give directions in relation to the administration of the trust.[40] The account holder's rights in these circumstances depend on trust law and on the terms of the trust instrument. They cannot therefore be said to be exactly equivalent to the corporate and property law rights vested in an investor that holds its securities directly from the issuer.[41]
>
> If the issuer defaults in its obligations in respect of the securities, the intermediary is not liable to the account holder for the default. The intermediary must, however, take such actions as are required of it to enforce the terms of the securities in accordance with the intermediary's fiduciary duties and the terms of its account agreement. This could involve suing the issuer or participating as a creditor in the issuer's insolvency. If the intermediary does not hold directly from the issuer but through a higher tier intermediary, it can enforce its rights on behalf of the investor only by enforcing its rights against the intermediary above it.

The Financial Markets Law Committee (FMLC) has expressed the view that:

> Customers (and persons claiming through them, including attachment creditors) can enforce their interests in securities only against the intermediary, and not against the issuer or any other intermediary. However, this is subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities or of a deed poll or contract arising under general law against persons not acting in good faith.[42]

The FMLC confirmed the above "Principle" reflects the current position under English law.[43]

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[38] See *Hayim v Citibank NA* [1987] AC 730. Lack of privity of contract should also prevent the account holder as a matter of contract law, from enforcing any contractual terms entered into by the issuer under the terms of the securities, although the Contract (Rights of Third Parties) Act 1999 could give an account holder contractual rights against the issuer if certain conditions are met.

[39] *Bristol and West Building Society v Mothew* [1998] Ch1, p 18.

[40] *Re Buckton* [1907] 2 Ch 406, 414.

[41] See A O Austen-Peters, *Custody of Investments Law and Practice* (2000) p31 in which the author states, "thus, whilst investors in non-intermediary custody retain the same direct ownership rights as any owner of securities would enjoy, an investor with assets in intermediary custody would effectively have exchanged his rights in the relevant securities against the issuer for a new set of rights against the custodian through whom he claims."

[42] FMLC, Principle 2(d).

[43] This approach is also consistent with the G30's agreement in January 2003 to identify - as a solution to conflict-of-laws problems associated with multiple parties in a chain of custody - the Hague "PRIMA" Convention. PRIMA was recognised as an important first step towards increased legal certainty regarding rights to securities ("the law governing the main proprietary issues of indirect securities holding is the law agreed upon as governing the account agreement between the investor and his direct intermediary, provided certain factual conditions are met"), but the report also pointed to complementary questions of substantive law that needed to be tackled. These included the need for effective protection against the risk of losing assets in the event of the

It cannot be said that any "weaknesses" in investor protection arise because of English law. As explained above, complications that do exist arise due to overseas securities holdings that are subject to the laws of the place where the securities are located. In the event of the default of a custodian, insolvency proceedings in the UK should recognise the entitlements of the investor as the owner of the beneficial estate; however, there is a risk that the legal systems of third countries might not respect the distinction. To reduce this risk, global custodians undertake due diligence to determine the steps required in each relevant legal system to ensure that the securities of their clients can be returned to them, without undue delay, should the global custodian be unable to continue in business. The global implementation of the Geneva Securities Convention would be a step to help overcome the conflicts of laws challenges inherent in dealing with cross-border chains of custody. Its effective implementation at the EU/EEA level should be the first priority.

intermediary's insolvency, for reshaping pledging formalities and the realisation procedures relating to collateral, and for harmonised rules of finality of settlement.

ANNEX I

Background on Comparative Law Relevant to Intermediaries Holding Customer Securities

With respect to the position in the United States, it should be kept in mind that the legal position is generally consistent with the rules that apply under English law. As Philip Paech notes, in a recent paper:

> The legal nature of a security entitlement is not exactly the same as legal ownership but is somewhat similar to an equitable interest under English law. In particular, security entitlements are separated from the intermediary's estate in the event of the latter's insolvency, hence they are not mere claims. The difference is that security entitlements do not 'overlap' as is the case with equitable interests under English law. Every security entitlement against an account provider is distinct from the security entitlements that the account provider itself holds. Consequently, there are legally disconnected security entitlement holders at each level of the holding chain, as opposed to beneficiaries under English law. As under English law, each account holder can only turn to its immediate account provider, not to one at a higher level.[44]

Contrary to what is suggested in the Discussion Paper, under the US Uniform Commercial Code (Article 8) and general market practice, securities are not in any way treated "like money" under U.S. law. Money can only be held *in specie* (i.e., physically) or with a bank on deposit (i.e., electronically or in so-called "bank money"), in which case the depositor has a personal claim on the bank (as a creditor entitled to repayment of a debt). This is not the case with securities. Indeed, a "securities entitlement" is defined in Section 8-102(a)(17) of the UCC as the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5, which rights and interests include:

- a pro rata property interest in the relevant financial assets
- securities intermediary's obligation to maintain sufficient financial assets to cover positions it creates by crediting securities accounts
- duty of securities intermediary to obtain and remit payments or distributions made by issuers
- duty of securities intermediary to exercise rights (e.g. voting) as directed by entitlement holder
- duty of securities intermediary to comply with transfer instructions of entitlement holder
- duty of securities intermediary to change entitlement holder's position to another available form of holding for which such entitlement holder is eligible (e.g., one can obtain a paper certificate only when and if the terms of issuance so permit)

Indeed, in contradiction to the Discussion Paper's stated premise involving comparison to markets like the U.S., UCC Article 8-503(a) provides:

> To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511.

[44] http://www.lse.ac.uk/collections/law/wps/WPS2012-11_Paech.pdf

Despite the clarificatory language of Section 8-503 about the nature of customers' ("entitlement holders") property rights, the UCC also provides protections to customers whose property interests in their securities entitlements suffer dilution leading to a shortfall, which the securities intermediary is not supposed to permit, but which is recognised as possible (e.g., as a result of a settlement failure at the level of the CSD). A key contingency in the UCC, which is intended to ensure that customers in such circumstances have at least a claim to the extent of any shortfall, is Section 8-511. Section 8-511 provides that in the event of a shortfall in financial assets, claims of entitlement holders have priority over claims of creditors. However, Section 8-511 also provides that entitlement holders do not have priority over "secured creditors having control over the financial asset". The reason for this exception has to do with ensuring legal certainty in respect of so-called "bona fide purchasers" and secured parties, thus enhancing systemic stability. It does not mean, however, that a securities intermediary may use, sell or pledge customer securities for its own purposes. It is intended as a contingency in the event third parties are considered innocent parties and in order to prevent contagion risk to the financial system. It should be noted that bank custodians in particular would not be in a position to use customer assets in their own business, anyway, because it is prohibited.

Finally, it should be noted that Section 8-503(b) goes on to provide:

> An entitlement holder's property interest with respect to a particular financial asset . . . is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the intermediary acquired the interest in that financial asset.

The approach described above is not – in effect - dissimilar from the approach in France. If anything, because of the codification in the United States under the UCC of the legal nature and effect of customers' rights in their securities when held in dematerialised form by an intermediary, things are more clear under U.S. law than under French law. The precise legal nature of dematerialised securities under the French *Code Civil* – and therefore the resulting obligations falling on those who would hold such securities "in custody" for others - are unsettled. According to M. Haentjens:

> [N]either the [French] legislature nor the judiciary have solved . . . classification issues after the dematerialisation. Although it is currently generally agreed that the accountholder – intermediary relationship is more in accordance with the contracts of *dépôt, mandat* and *louage d'ouvrage* than with other contracts, the discrepancies of some of the main elements of *dépôt* with securities custody are not solved. More specifically, the impossibility to delivery [*sic*] dematerialised securities *in specie* on a request for retrieval, and to physically deposit these securities have been argued to render a classification as *dépôt* inappropriate. The contracts of *mandat* and *louage d'ouvrage*, on the other hand, seem accurate, but do not indicate the main characteristics of securities custody, maintenance of securities accounts and preservation of the assets to which those accounts refer. Practice therefore correctly considers the relationship, it is submitted, a *sui generis* contract, but that approach has not been generally accepted.[45]

[45] M. Haentjens *Harmonisation of Securities Law, Custody and Transfer of Securities in European Private Law*, Kluwer Law International, 27 September 2007: *see*, para 6.7.2.

In practice, therefore, "qualification is avoided by classifying the custodian no longer as *dépositaire*, but as *conservateur*, while the contract itself is classified as *conservation*."[46] Haentjens concludes:

> The nature of investors' interests in securities held with an intermediary, it is submitted, is a combination of rights *in rem* and *in personam*.[47] The are dependent on the fulfilment of the investor-custodian relationship and the custodian's administration of the investor's securities account. On the other hand, a book-entry into a securities account is a constitutive element of ownership vis-à-vis third parties, while it provides and investor with a challengeable proof of ownership vis-à-vis his counterparty to a transfer.[48]

It therefore seems clear that even in France investors may under some circumstances have "claims" on intermediaries holding French securities in a manner that is similar to "claims" that may be asserted against securities intermediaries in the United States. Indeed, the legal nature of such claims against intermediaries – and the circumstances in which they would arise - are not very different as between the two regimes at the end of the day.

[46] M. Haentjens, *The Law Applicable to Indirectly Held Securities, The Plumbing of International Securities Transactions*, Allen & Overy Onderzoekstreeks, 2006, p. 51, citing De Vauplane & Bornet (2001), nos. 970 and 968.
[47] *Ibid.*, citing Ripert & Roblot (1996), nr. 1795.
[48] *Ibid.* Haentjens goes on to point out, "The French legislature speaks of accountholders as *propriétaires* (owners); Article L.431-6 C. mon.fin. Again, this approach does not seem very consistent, since reference to revendication in the custodian's insolvency has been avoided in the very same article and since investors are mere unsecured creditors in the case of any deficit remaining after a pro rata apportionment."

ANNEX II

Key Conclusions and Considerations Contained in the Reports of the TFAX Task Force and the T2S Taskforce on Shareholder Transparency

The TFAX task force concluded that requiring the redundancy of segregation all the way through the chain and use of T2S to pass on registration information would introduce intolerable operational complexity and risk of error:

> "The TFAX recommends minimising account segregation, in particular at the higher levels of the settlement chain (e.g. issuer CSD level). If account segregation is required, this should be implemented at the lowest possible level of the settlement chain. However, investor and issuer CSDs should be free to offer their participants the possibility to operate segregated accounts on a voluntary basis."[49]

The TFAX analysed two separate tools that can be used to transmit and maintain information. In addition to addressing the "pros and cons" of using account segregation through the chain of custody in order to link securities accounts with specific pieces of information, the TFAX also analysed the possibility of requiring additional information in T2S settlement messages as a solution. The task force also concluded:

> "Under current conditions (e.g. unharmonised information requirements and T2S specification) the TFAX recommends not to use T2S settlement messages as a means of passing registration details. The TFAX recommends that account segregation for the purpose of registration, which needs to be propagated throughout the settlement chain, should be avoided."[50]

As the task force also pointed out, a key overriding principle is that the appropriateness of a potential tool for a specific identified task depends in large part on the recipient of the information necessary to perform the task and whether the information provided needs to be maintained by each party in the custody chain down to the end investor. Examples of recipients of information might include register-maintaining entities (for registration processing), national tax authorities or tax withholding agents (for tax processing), or custodians (i.e., the last intermediary) in the event of a portfolio transfer.

The TFAX identified the following non-exhaustive potential solutions: (1) the possibility of nominee registration, (2) linking the transfer of rights to settlement such that there is no post-settlement event questioning the transfer of rights, and (3) the abandonment of transaction-by-transaction registration completely. All of these options would be aimed at further integration of registration and settlement as a means of ensuring the realignment of both processes.[51]

We commend the Final Report of the T2S Taskforce on Shareholder Transparency as setting out a framework for sensible alternatives for ensuring sufficient transparency for issuers going forward.[52] The Taskforce's report summarises its main analysis and findings and recommends and documents two technical solutions. A recommended "decentralised scenario" is described as being capable of implementation in advance and without T2S and,

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[49] European Central Bank, T2S, *Report of the Task Force on Adaption to Cross-CSD Settlement in T2S*, 28 November 2012, page 8.
[50] Ibid., page 16.
[51] Ibid., page 4.
[52] http://www.ecb.int/paym/t2s/governance/ag/html/subtrans/index.en.html, 28th February 2011

assuming that certain pre-requisites as described in the report are implemented, the Taskforce states that cross-border shareholder transparency across all layers of the holding chain would be "significantly improved".[53] The Taskforce concludes by recommending to the T2S Advisory group that it:

> 1. Propose that CSD links arrangements, in the context of the decentralised solution, should be submitted to the European Central Securities Depositories Association (ECSDA) for consideration and subsequent endorsement;
> 2. Consider whether it would be worthwhile to further analyse the policy, technical and economic implications of a so-called "centralised solution" (utilising T2S as a messaging service to contact the Issuer and Investor CSDs' participants in order to request a breakdown of their holdings) at a later stage (e.g., as of 2014 when it would be clear to what extent the decentralised model may be implemented); or whether such an expansion on the scope of T2S should not be analysed any further;
> 3. Take note that the Taskforce has finalised the proposal for the Shareholder Transparency messages to be used and they will be submitted to the ISO standards body for assessment and approval;
> 4. Present the proposals for exchanging shareholder data to the relevant European Associations of the CSDs, Issuer Agents and Custodian Banks (ECSDA, European Issuers, GCA, EBF etc) for consideration regarding subsequent endorsement and implementation; and
> 5. Discuss and approve the proposed changes in amending the Transparency Directive II; and agree that the Advisory Group chairman and/or Taskforce chairman approach the European Commission with the proposal on behalf of the Advisory Group.

We emphasise the importance of the last recommendation above due to legal considerations to which the Taskforce calls attention in its report:

> "The issue of shareholder transparency in the context of securities held with intermediaries ranges between the poles of the corporate law of the issuer and the custody law (in particular banking law) of the respective intermediary. Corporate laws may (and often do) acknowledge the interest of the issuer to know the identity of the investors that eventually control (some of) the essential corporate processes of the issuer, e.g. through their voting rights in the general annual meeting or the tendering of their shares in a takeover situation. The custody/banking laws that apply to securities intermediaries, on the other hand, look at the confidentiality of the account relationship, frequently without regard to the nature of the assets held in those accounts."[54]

The work of the TFAX and T2S Taskforce on Shareholder Transparency sets out detailed analysis explaining why legal segregation of accounts through the custody chain to the CSD is suboptimal as a means of ensuring shareholder transparency vis-à-vis issuers but at the same time recommends effective and achievable means of attaining this goal. In this connection, we emphasise that reconciliation requirements must be stringently applied in the omnibus setting. In the end, the question comes down choosing the better approach, each with its own strengths and weaknesses: continued use of omnibus accounts will still depend to some extent on clear and effective operational and reconciliation policies whilst a plethora of segregated accounts throughout the chain of custody would entail significant structural risks.

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[53] Ibid., page 23.
[54] Ibid., page 17.