
AFME Note on Securities Law Reform

6 May 2015

EXECUTIVE SUMMARY

The Association for Financial Markets in Europe, AFME¹, and its predecessor organisations have accompanied EU work in the field of post-trading of securities since its beginnings in the late 1990's. Much has already been achieved on the way to a safer and more competitive EU post-trading sector, both before and after the Financial Crisis. However, there was little progress in the field of what has been termed the 'legal barriers to post trading' by the Giovannini Reports, notably in respect of developing a more consistent, safer and more efficient legal framework for securities holding.

This is why AFME continues to contribute to the debate on why and how to reform securities law and regulation. The fact that the debate has changed its focus during the financial crisis does not mean that the relevant problems have disappeared. In fact, AFME members involved in the holding and administering of client securities need to work with the underlying securities law on a daily basis, in particular in a cross-border context. This note is informed by that experience; however, in the interests of space, it reflects the views of AFME on the areas that require continuing focus in the context of securities law reform, rather than prescribing the technical steps required to implement policy choices in all relevant areas. AFME is always ready to discuss these areas in greater detail.

Safe financial markets require efficient risk management and risk mitigation. One of the most important risk mitigation tools is financial collateral provided over investment securities. It is therefore of utmost importance that financial collateral can be provided in a legally clear and safe way. The Financial Collateral and Settlement Finality Directives marked very important steps in that direction and are fully supported by the financial industry.

However, more needs to be done to overcome legal and regulatory problems not covered by these Directives. Notably, there is need for the following elements to be addressed.

- How are securities actually acquired in legal terms? How are collateral and security interests provided in legal terms? In relation to both, AFME believes that credit and debit account entries should become legally constitutive for valid acquisition and disposition.

¹ AFME is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players. We focus on a wide range of market, business and prudential issues and offer a pan-European perspective, bringing to bear deep policy and technical expertise and constructive influence with European and global policymakers.

- How does commercial and insolvency law address a shortfall in securities, in particular in case of insolvency of an intermediary? In this respect, AFME believes that there should be, first, rules preventing loss of client securities, in particular imposing segregation of client assets from the intermediary's own assets. However, second, shortfalls cannot be entirely prevented either by law or regulation. Therefore, AFME proposes to harmonise, to some extent, loss sharing and compensation mechanisms.
- How can collateral securities be validly acquired in a generally anonymous market where there is no possibility to verify the validity of the collateral provider's legal position? Here, AFME believes that EU law should provide for a harmonised understanding of 'good-faith acquisition' of securities and securities collateral.
- As long as the applicable law is the domestic law of Member States, it is important to be very clear about *which* law has to be applied to a certain case. Therefore, the existing conflict-of-laws rule of the FCD should be extended to all areas of holding, acquisition and disposition of securities.

Lastly, AFME believes that it might be necessary to address certain aspects – such as, for example the conflict-of-laws rule – in a Regulation. As regards other aspects, an appropriate way seems to be an extension of the Financial Collateral Directive to all other relevant aspects.

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INTRODUCTION

Efforts to modernise securities law in Europe date back to the late 1990's and early 2000's, culminating initially in the entry into force of the Settlement Finality and Financial Collateral Directives and in the adoption of the second Giovannini Report. The first Giovannini Report identified fifteen barriers to post-trading in Europe, four of which belonged to the area of securities law. Since then, considerable further work has been undertaken and new EU legislation has been passed. The core part of the securities law reform agenda, a Commission project that is styled "Securities Law Legislation" (SLL), has been delayed several times. Its focus has largely changed after the financial turmoil, and parts of the projected SLL have been absorbed by other pieces of legislation and regulation; in particular, the Central Securities Depository Regulation (CSDR), the Shareholders Rights Directive (SRD) and the European Market Infrastructure Regulation (EMIR).

The Association for Financial Markets in Europe (AFME - www.afme.eu) still believes that EU legislation addressing issues of certainty and clearness of the law surrounding securities holding and acquisition is crucial for the long-term development of the internal market for capital and financial services. In particular:

- The stability and safety of the markets requires legal and regulatory rules to be clear and compatible across jurisdictions.
- The EU financial market requires a more homogenous legal base in order to strengthen its efficiency and competitiveness.
- The stability and safety of the markets, on the one hand, and efficiency, on the other hand, are not mutually exclusive goals. In fact, we are convinced, both go hand-in-hand.

Therefore, AFME urges policy makers to continue the work on securities law reform and to adopt focussed and comprehensive legislation in this field. The purpose of this report is to give guidance on the necessary key elements of securities law reform by providing an in-depth picture of the safety and efficiency problems the industry and market participants require legislative assistance to address.

Data shows that between 5 and 95% of investments in the different European financial centres are allocated to cross-border securities. Typically, in large financial centres like London, Frankfurt and Paris, between 30 percent and 70 percent of investment are allocated to cross-border holdings. In these cases, a purely domestic legal analysis cannot yield a result which is sophisticated enough to deal with the issues peculiar to cross-border holdings.

In addition, legal issues relating to securities holding and transfers are strongly connected to domestic insolvency law and property law. Both are traditionally applied on a mandatory basis. Therefore, market participants are unable to simply choose one jurisdiction's law, as they might to regulate their contractual relationships, and have the entire situation governed by it. While AFME is not asking for this principle to be changed, the situation shows that cross-jurisdictional legal certainty heavily depends on the compatibility of these mandatory domestic laws. **This question is at the centre of any EU securities law reform.**

THE MAIN CONCERNS OF THE MARKET AND PROPOSED SOLUTIONS

The first consequence of the lack of harmonisation across Europe in relation to holdings of cross-border securities is legal uncertainty. We understand by legal uncertainty that the law does not deliver the expected result despite the parties having accomplished all necessary steps to achieve that result. The financial industry's most important concern relates to the valid acquisition of collateral and to related aspects which flow from that concern, such as good faith acquisition and loss sharing.

From the collateral-taker's perspective, collateral over securities involves the acquisition of securities under a title transfer financial collateral arrangement or the acquisition of limited *in rem* rights in securities under a security financial collateral arrangement. Both the collateral taker and the collateral provider have a vital interest in the underlying legal framework being reliable and interpreted in a consistent manner across all Member States:

- The collateral taker's risk management depends on the enforceability of its financial collateral arrangement involving the collateral, alongside close-out netting arrangements.
- The collateral provider expects that the redelivery of collateral securities is legally clear and easy. It is of paramount importance that securities collateral does not get 'trapped' in another market participant's insolvency.

The entire wholesale financial market uses collateral and netting as risk mitigation mechanisms, as do central banks, and the amounts involved are very significant. Market participants that are unable to enforce security interests in collateral upon which they have relied, or to whom their collateral cannot be returned, might face important, unexpected losses in their counterparty's insolvency. Depending on the scale and on the market context, such losses can threaten the continuing operation of the firm.

AFME wishes to take the opportunity to put forward a few ideas on the future evolution of the legal and regulatory framework for securities holding. These ideas concern: (i) the extension of the Financial Collateral Directive; (ii) the protection of the good-faith acquirer; (iii) avoiding excess credit entries; and (iv) extension of the existing EU conflict of laws rules.

Going beyond the scope of the Financial Collateral Directive

The 2002 Financial Collateral Directive (FCD) is a very successful element of the EU's financial market legal framework. It addresses some of the most important concerns relating to the acquisition of collateral, but some other important aspects still require attention.

Notably, the FCD makes sure that the Europe-wide use of financial collateral arrangements does not face the typical threats encountered in cross-jurisdictional transactions; notably, the risk of re-characterisation or the need to comply with formalities in several jurisdictions. Further, it assures that the use of top-up collateral and the substitution of collateral assets will not undermine financial collateral arrangements, and it guarantees that close-out netting, which is crucial for the safe use of financial collateral arrangements, is enforceable throughout the EU. In addition, it allows financial market participants to sell collateral on a regulated market in case of default of a counterparty, which reduces the risk of a massive loss of value while collateral goes through public auction or a similar enforcement procedure. Lastly, it determines the law applicable to securities collateral as the law of the relevant account.

Yet, it would be useful if the Commission could look again at whether Members States have implemented the FCD fully, as it appears that there remains a risk that some financial collateral arrangements may need to be registered in the Member State where relevant securities are issued in order for the collateral arrangement to be enforceable, despite such registration requirement running contrary to the purpose of the FCD.

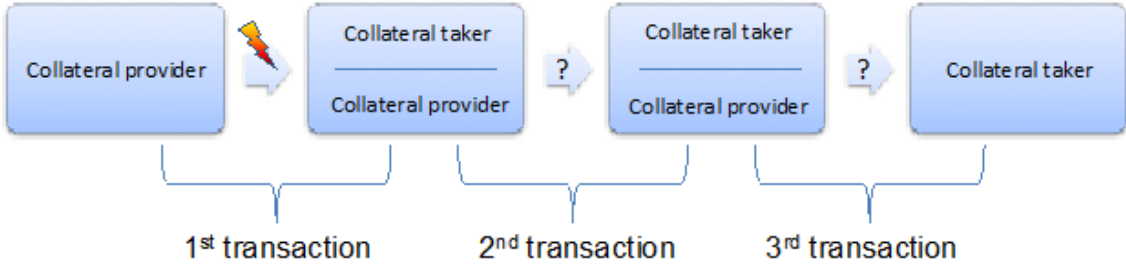
However, these points concern mainly, and crucially, the enforceability of the financial collateral arrangement; i.e., reducing the risk that it can be defeated unexpectedly in a situation of insolvency. The FCD does not address the question of “if, when, what and how a collateral taker acquires” an interest in collateral. That is, the *substantive* question of acquisition is entirely left to national laws. These are sometimes not consistent, in themselves, for historic reasons. Further, and more crucially, they differ considerably, which may lead to problems in cross-border scenarios. To address these shortcomings, the following issues should be addressed.

Clear rules for acquisition and disposition

The rules on how collateral securities are acquired differ between jurisdictions. Some laws link the legal enforceability of acquisitions and dispositions to the making of book entry credits and debits. In other jurisdictions, the legal value of credits and debits is unclear and therefore subject to challenge. **As the system of credit and debit book entries is widely used throughout EU markets, it appears to be a natural determinant of the legal position an acquirer obtains.**

Good-faith acquisition

An important concern relates to the availability of good faith acquisition. In an anonymous market involving fungible financial instruments which may be registered in the names of nominees acting for multiple end clients, acquirers can never know who previously owned the relevant assets and whether all previous acquisitions of the relevant securities were legally valid. Therefore, they need to be able to rely on the law ensuring their valid acquisition, even if one of the earlier acquisitions subsequently turns out to be invalid. For example, a court decision rendering an earlier acquisition void might create significant concern among market participants that have acquired these securities subsequently – thus creating uncertainty as to their title to assets that they thought were validly acquired.



Given the anonymity and the frequency of acquisitions in the market it is obvious that the entire market naturally relies on the principle of good faith acquisition. **Therefore, the legal framework for good faith acquisition needs to be consistent throughout the EU.**

Avoidance of excess credit entries

It is obvious that good faith acquisition must not and cannot lead to an inflation of the number of securities originally issued. If an earlier transfer was void but the later acquirers acquire in good faith, the same securities seem to 'exist twice', notably at the level of the first transferor and at the level of the last acquirer. In practice, the intermediaries involved may *ad hoc* remedy any imbalance of that type until responsibilities of the parties involved are clarified, in particular by applying own securities of the same issue to the "excess". However, **the law must provide for a mechanism that levels out any excess credit entries by determining which party must suffer the loss of the securities.** The issue is different, however, from the question of who is ultimately responsible to compensate the injured party for that loss. In that sense, the question of distribution of loss in securities and responsibility for the loss have to be distinguished.

Conflict of laws

The conflict of laws rule of the FCD is restricted in scope to collateral transactions. We believe that a general conflict of laws rule for all dispositions and acquisitions of securities is needed. **The conflict of laws rule should therefore be extended and provide that the proprietary aspect of the holding and transfer of securities should be governed by the law of the country where the securities account is maintained (i.e., where it is located), whether the account provider is market infrastructure (CSD) or a market participant.**

HOW TO PROGRESS?

The recent proposals in respect of SLL addressed both regulatory and commercial law aspects. Commercial law concepts should be disentangled from regulatory (including supervision) considerations to provide for greater simplicity and more effective reform measures.

- **Commercial law aspects should be addressed in an independent legal instrument or could be integrated within a future, more comprehensive, version of the Financial Collateral Directive.**
- **Regulatory issues could be addressed in an instrument either within, or complementary to the CSDR: however, it would need to apply to all securities intermediaries.**

AFME believes that it is crucial to clearly define what is really needed in order to render collateral taking safer.

AFME would be very happy to further develop these elements to any interested party.

DETAILED CONSIDERATIONS

Conflict-of-laws rules

Just as any court seized with questions regarding securities acquisition and disposition would have to determine which law is applicable, we believe that a consistent conflict-of-laws regime is the first priority. Therefore, the conflict of law rule contained in the FCD should be extended to all cases (i.e., not only in respect of collateral arrangements) for determining which law governs proprietary issues in relation to securities, such as their transfer, use as collateral and security arrangements.

Conflicts with any governing law provisions of any other current EU legislative measures should be avoided at all costs. Multiple rules on the applicable law to settlement finality could lead to differing results depending on which legislative measure applies to intermediated securities holdings, which in turn could lead to increased risk. AFME believes that the current rule of Article 9 of the FCD,² though not ideal, is a good compromise and definitely better than having no general, harmonised rule.

Concepts for acquisition and disposition

Book entry and finality

Legal systems at the national level determine legal requisites of transfer of securities. It is not possible or necessary to harmonise these legal systems. Instead, to the extent possible, the focus should be on clarifying and harmonising **the moment at which the acquisition of legal title (or, in case of a security interest, the acquisition of the limited right *in rem*) occurs**. Harmonisation in this respect should happen on the basis of the following guidelines:

- At settlement system level, the moment of transfer should occur at the moment of settlement under the rules of the relevant settlement system (whether operating in the EU or not) and not on trade date or some other time;
- At account provider level, an account provider should undertake to debit or credit securities to an account holder's account at or prior to the point of settlement, which should be determined with reference to the rules of the relevant settlement system, which in turn may be a designated settlement system under the Settlement Finality Directive or some other securities settlement system, including a non-EU system, as per the third country CSDs regime of the CSDR; and
- Account providers and account holders should be able to rely with finality on debit and credit entries to relevant securities accounts. However, there need to be rules addressing the issue of erroneous credit and debit entries.

Whilst the Settlement Finality Directive protects securities settlement in a designated securities settlement system against the insolvency of a participant to the system as of the moment of

² Article 9 of the FCD:

1. Any question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country.

2. The matters referred to in paragraph 1 are:

(a) the legal nature and proprietary effects of book entry securities collateral;

(b) the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and the provision of book entry securities collateral under such an arrangement, and more generally the completion of the steps necessary to render such an arrangement and provision effective against third parties;

(c) whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest, or a good faith acquisition has occurred;

(d) the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

entry of the transaction into the system, nothing addresses settlements in the books of intermediaries (i.e., settlement internalisers). It is therefore necessary that future securities law legislation provides that any transaction entered into the books of an account provider must settle, even if the account provider or *another* client of the account provider is in default. However, the account provider shouldn't be obliged to settle one leg of the transaction if it can't settle the other leg of the transaction against the participant or client in default.

The fundamental distinction between transfer and the granting of a security interest

There should be a clear distinction between:

- crediting and debiting of securities accounts, as dispositive incidents of transfer of ownership, whatever the underlying consideration could be (outright sale or title transfer collateral). By this means, the circumstances under which an account holder's ownership rights would arise and cease would be clarified.
- the means of providing collateral under a security financial collateral arrangement, which operate to vest possession and/or control of the subject securities in the collateral taker and limit an account holder's or third parties' access to those securities.

AFME believe this would further the twin objectives of (a) ensuring investor protection through clarity in respect of when ownership is actually transferred on the enforcement of a security interest by a collateral taker granted under a collateral arrangement and (b) clarifying that title does not transfer on the provision of securities under a security financial collateral arrangement under the FCD.

However, AFME believes that the specificities of the manner in which securities may be effectively provided as collateral (*e.g.*, earmarking, removal of earmarking, control agreement, other agreement in favour of an account provider) should be left to national law.

Good faith acquisition

There should be a harmonised rule on good faith acquisition setting out that securities that have been acquired by the aforementioned method are protected against challenges from earlier owners on grounds that an earlier transfer was not valid.

EXCESS CREDIT ENTRIES AND SHORTFALLS

Excess credits and shortfalls are the two flip sides of the same coin. Both terms refer to a situation in which there is a mismatch, at the level of an account provider, between securities actually available for delivery to or on the instructions of account holders and the aggregate number of securities credited to account holders' securities accounts. The phenomenon can occur for a variety of reasons.

Causes

There are a number of potential causes for excess credit entries, or shortfalls.

Ringfencing Risk

Client assets could be treated as assets of the intermediary, which could then be used to meet the claims of general creditors in the context of an insolvency proceeding over the intermediary's estate.

Intermediary B maintains securities accounts clients C1-C10. There are 4,500,000 BCI securities credited to these accounts. Intermediary B has also a number of BCI securities on his own book, notably 200,000, which he keeps in order to be able to fulfil obligations under contractual settlement arrangements (i.e. in order to be able to immediately credit BCI securities to clients accounts, even before the system's settlement date). Intermediary B keeps all securities through Intermediary S, who is a clearing member. The law prescribes to keep client and own securities in segregated accounts. However, due to an oversight, only 3,500,000 BCI securities are booked to the 'client' account with Intermediary S, while 1,200,000 BCI securities are booked to the 'own' account. Intermediary B becomes insolvent. Following the insolvency administrator, the mistaken attribution to the 'client' and 'own' accounts of Intermediary S has legal effects. As a consequence, 1,200,000 BCI securities are regarded as property of the intermediary and form therefore part of the pool available for distribution amongst general creditors. Clients C1-C10 face an aggregate loss of 1,000,000 BCI securities.

Ringfencing and Addressing Shortfalls in Client Positions

AFME calls for an EU rule prohibiting that competing claims should be allowed between account holders and an intermediary's creditors to financial instruments which are held for account holders: securities held for account holders must be held in such a manner so that they can at any given moment in time – and irrespective of the intermediary's insolvency or claims by other creditors of the intermediary, but subject to rights of the intermediary under insolvency or commercial law – be transferred to another securities account. This requires: (a) that they can be identified and accessed following easy and quick procedures from an accounting and operational point of view; and (b) that the legal title cannot be challenged. Ranking of account holders rights against an insolvent intermediary with claims by general creditors against that intermediary should be rendered unnecessary, since the financial instruments to be returned to the account holder are not the property of the intermediary.

Further, insolvency rules should contain a clear rule on how potential shortfalls in client securities holdings (even though they are unlikely to occur) should be allocated to account holders. There is no need for uniformity on this issue; however, clarity is needed in order avoid legal uncertainty at the moment of insolvency and to allow for a speedy settlement of the issue. Member States' rules could provide for solutions such as the following:

- The loss is allocated to specific account holders which are closer to its occurrence than other account holders (tracing). However, tracing is extremely complicated in practical terms. Consequently, the law should contain simple rules on tracing and otherwise fall back on solutions such as loss-sharing.
- The loss can be shared on a rateable basis amongst all account holders holding that specific security.
- The loss can be shared amongst all account holders holding the lost securities or other securities with that intermediary.

In combination with any of the above, the loss can be compensated by the intermediary's own holdings in the relevant security or in other securities. However it is important that in case of insolvency there is immediate clarity on whether a particular account holder or a particular set of account holders have suffered a loss or not.

Good-faith acquisition

It must be recognised that the application of good faith acquisition rules in combination with debit and credit records in book entry accounts at different account providers can lead to inconsistent and conflicting records. For example, if the transfer of a particular financial instrument between two parties is determined by a court to be defective, then a reversal of the transfer in the books of an account provider could be problematic. In practical terms, they will still exist at the level of the disposer whose transfer failed—a court might, in particular, rule that that disposer never lost his securities. However, as the securities have been transferred to other, potentially several, acquirers in the meantime, there will be an ultimate acquirer who also ‘has’ the securities. As there can never be more securities than originally issued by the issuer the law needs to address and remove this imbalance. **Again, the legal framework for good faith acquisition needs to be consistent throughout the EU, as account of interested parties might be governed by different laws when they are located in different jurisdictions.**

Alienation Risk

There is at least a theoretical possibility that client assets could be used as collateral for the obligations of an intermediary towards a creditor and retained or realised by that creditor on that basis, should the intermediary not perform on its obligations. Alienation risk arises if the relevant intermediary makes use of client assets to secure its own obligations without the consent of the client. Although re-use in such circumstances is generally prohibited by the terms of the intermediary’s appointment, the possibility exists that an intermediary may engage in impermissible conduct, either knowingly or negligently.

This is where the supervisory aspects of securities law are of utmost importance, as the role of commercial law is not the prevention of wrongdoing. Existing regulations already require intermediaries to take steps to protect client assets. **However, commercial law can provide an answer on the proprietary situation; in particular, by providing that, in the case of insolvency, the insolvent intermediary’s own securities are attributed to account holders.**

CLIENT ASSET SEGREGATION

The use of intermediaries is essential to the efficient conduct of business. In the sphere of the exchange of ownership of commodities or other tangible property, delivery of commodities or other tangible property typically relies upon a producer or distributor using third party transportation and warehouse services, which alienate the producer or distributor from physical possession or control of the commodities/tangible property. However, in such a situation, the law does not alienate the producer or distributor from its proprietary interests only because physical possession or control has passed to an intermediary. Rather, it recognises the proprietary interests of the producer or distributor, so that it cannot be estranged from them. Should a dispute arise with the third party providing transportation or warehousing services, then the law will generally intervene to protect the proprietary interests of the producer or distributor. While there are limitations and exceptions to these principles, the essential point is generally recognised.

Insolvency rules should be harmonised, between Member States, so that there is clear recognition of the segregation of financial instruments held by a firm for its clients, or by a central counterparty, in respect of client collateral. Minimal intervention would be required to apply a rule that would give greater assurance to investors and support the obligations already

imposed on firms to achieve segregation. While title transfer and security interest arrangements should continue to be recognised, the presumption should be that a firm holding securities for its client, which is under a legal obligation (whether statutory or contractual) to segregate its clients' from its own financial instruments, has done so. Such a rule would support the return of client financial instruments upon the insolvency of such firm, and could be applied, irrespective of the legal system under which they are held, in a consistent and certain manner.

In operational terms, each intermediary in the chain must provide segregation of securities, where securities that an account holder holds for its own account are segregated from securities that the account holder holds for its clients' account.

RECOGNITION OF DIFFERENT HOLDING STRUCTURES

The recognition of different holding structures of foreign legal systems, without the need for each legal system to incorporate other structures and legal concepts into its own legal system, is indispensable to overcoming perceived legal barriers and to achieving increased efficiency and cost effectiveness.

In order to retain efficiencies, prevent unnecessary cost and reduce the possibility of error, express provision should be made for use by securities intermediaries of omnibus accounts with account providers and settlement systems.

SCOPE, FORM, APPROACH AND INTERNATIONAL COMPATIBILITY

Future securities legislation should apply to transferable securities:

- As defined in directive 2014/65/EU, art. 4(44), i.e., securities that are capable of being credited to a securities account, which also corresponds to Article 1(a) of the Geneva Securities Convention;
- That are dematerialised or immobilised in accordance with the CSDR;
- That are credited to securities accounts maintained by account providers for account holders with a view to safe-keeping and administration.

AFME considers a regulation the appropriate legislative form, especially in respect of those parts of the legislation that must not suffer from incoherent or inconsistent transposition into national laws.

Any future EU securities legislation should clearly delineate whether it applies to market infrastructure providers (such as CCPs, CSDs and clearing houses) and their agents. To the extent that securities legislation does not apply to market infrastructure providers, it should provide that their actions in accordance with their own relevant legislative regimes (including non-EU regimes where relevant) shall not prejudice account providers operating under the European securities legislation. For example, EMIR provides at Art. 47(5) that a CCP must ensure that "the assets belonging to a clearing member are identifiable separately from the assets belonging to the CCP and from assets belonging to a third-party custodian." Where securities have been transferred to the CCP under a title transfer arrangement, it would, however, seem that the only way to comply with EMIR's requirements is if such a CCP treats these securities as

nevertheless belonging to the relevant clearing member or clearing client (and therefore hold them in the "client" account with the relevant securities settlement system or custodian). This aspect of EMIR, therefore, would seem difficult to reconcile to the crediting and debiting of securities accounts as being dispositive incidents of transfer of ownership.

There is significant need for consolidation of the existing EU *acquis* in this area. The new securities law need not replace the FCD and SFD. However, it needs to be compatible with and build on these two landmark pieces of legislation. Further, alignment between the new legislation and MiFID/MiFIR, AIFMD, UCITS, EMIR and the CSDR is crucial, mostly regarding regulatory aspects, but also regarding those provisions having a commercial, property or insolvency law impact.