afme/ post trade

31 DECEMBER 2010

REPLIES TO THE CONSULTATION DOCUMENT OF THE SERVICES OF THE DIRECTORATE-GENERAL INTERNAL MARKET AND SERVICES

ON LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

The Association for Financial Markets in Europe (AFME) through the Legal Committee of its Post Trade Division[1] is pleased to respond to the consultation of the Services of the Directorate-General Internal Market and Services of the European Commission on the Legislation on Legal Certainty of Securities Holding and Dispositions.

The Legal Committee of AFME's Post Trade Division, comprising senior legal counsels of its member firms, and its predecessor organisations[2] have strongly and constantly emphasized the need for securities law reform in Europe since the EU Commission's Consultation on Clearing and Settlement in 2002. In particular, it actively supported the process of the present legislation on legal certainty of securities holding and disposition through numerous contributions reflecting the combination of lawyers' and practitioners' views.

1. Information about the respondent

- *Name and address of the respondent:*
  Association for Financial Markets in Europe (AFME)
  St. Michael's House
  1 George Yard
  London
  www.afme.eu

- *Field of activity of the respondent's members:*
  The respondent's members conduct domestic and cross-border

[1] The Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. Representing its members towards market infrastructure organisations and public authorities, the Post Trade Division acts as an agent for change providing and supporting solutions in the securities clearing, settlement and custody space to reduce risks and costs to market participants.

[2] The AFME Post Trade Division was preceded by the European Securities Services Forum (ESSF), previously the European Securities Forum (ESF), and the London Investment Banking Association (LIBA).

securities operations in the EU/EEA area in their capacity as financial institutions in a wide range of banking activities for their customers and for their own account.
The respondent's members are securities account providers in the context of European and national regulated activities.

- *AFME's members and membership structure*
  Of the broader AFME membership (see www. afme.eu) the following members – investment banks, regional and global custodians and wealth management / private banking – actively participate in the Post Trade Division:
  Bank of America Merrill Lynch
  Barclays
  BNP Paribas
  BNY Mellon
  Citi
  Credit Suisse
  Deutsche Bank
  Goldman Sachs
  HSBC
  J.P.Morgan
  Morgan Stanley
  Nordea
  RBS
  UBS
  UniCredit

2. Key points of our consultation response

In essence, it is our view that

- the present highly welcome law reform, the Securities Law Directive, should be compatible to the highest possible extent with the Unidroit Convention on Substantive Rules regarding Intermediated Securities (**Geneva Securities Convention**); however, within Europe we hope for a more ambitious form of harmonisation beyond mere compatibility between European legal systems;
- in regard of the **conflict-of-laws** regime account providers should have the option to have all property rights of book-entry held securities governed by a single relevant law, namely the law of the location of their register or system, irrespective of the fact that they may enter through their branches in an account relationship with their account holders;
- a functional system should be designed that clearly separates the two methods of acquisition and disposition (crediting and debiting), which

lead to a **transfer of ownership**, from the four methods of evidencing limitations to securities credits, which are used for **taking collateral**;

- the recognition of different **holding structures** (including nominee and omnibus accounts) is indispensable to the comprehensive removal of the legal barriers and to achieving increased efficiency and cost effectiveness; however, further steps of harmonisation will be required to enable the unhindered exercise of rights attached to securities;
- the EU Commission should consider to choose **the legislative f**orm of a **Regulation** for those parts of the legislation that must not suffer from incoherent transposition into national laws;
- the proposed regulation of **charges levied by an account provider** is inopportune as the comparison with the payment area is inappropriate given the continued fragmentation e.g. in the field s of company law and fiscal regimes;
- the removal of Giovannini **Barrier 9** (location of securities) should be part of another regulatory initiative of the EU Commission in 2011 as it appears not to be dealt with in the Securities Law Directive.

3. Responses to the questionnaire

1. Objectives

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

These objectives appear legitimate.

There are difficulties in the cross-border exercise of rights flowing from securities held through securities accounts. Those difficulties are often of a purely operational nature and not of legal nature. We would like to draw the EU Commission's attention to the Market Standards on Corporate Actions Processing and the Market Standards on General Meetings. The future Securities Law Directive should provide sufficient legal basis for those market standards. Initiatives like T2S and the harmonisation of settlement cycles will further remove barriers.

We would like to draw the express attention of the European Commission to the Financial Collateral Directive, which has achieved an outstanding piece of harmonisation on a highly important aspect of securities transfer and holding. The FCD's achievement is a harmonisation of the methods of taking collateral by distinguishing title transfer collateral and security collateral. The current approach lacks the necessary ambition of harmonising the rules governing the holding and disposition of securities and leaves important questions unanswered.

While retaining the functional approach, we encourage the European Commission to take the same approach as the one adapted for the Shareholders Rights Directive, the Financial Collateral Directive and the Finality Directive. We fear difficulties resulting from non-harmonised European legislation.

We have a comment on the integrity of the issuance. The EU Commission's consultation document provides that "Equally, EU law should not cover the functions of creation, recording or reconciliation of securities, against the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar" (p. 4 *in fine*). This results in an important lack in the integrity of the issuance. The Unidroit Convention on Substantive Rules for Intermediated Securities (the Geneva Securities Convention) directly inspires this sentence (art. 6). However, it means that:

a. if the issuance is registered in an issuance account maintained by the CSD, the integrity of the issuance is preserved but
b. if the issuance is not registered in an issuance account but only in the issuer's register, the integrity of the issuance is out of the scope of the future legislation.

This distinction is not appropriate in order to include or exclude the integrity-check from the future Securities Law Directive and we encourage the EU Commission to provide for a rule which preserves the integrity of the issuance at the highest tier of the intermediary chain, i.e. between the issuer and the first intermediary (most often the CSD, possibly via registrars).

2. Shared Functions

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

No comment

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

No comment

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

No, we see no difficulties in connecting transparent holding systems to non-transparent holding systems. The French investor purchasing Swedish Securities credits the securities to a securities account maintained by an intermediary in France. The French intermediary uses the services of a Swedish intermediary (a "person other than the account provider" in Principle 2.1 (1)), who operates the investor's account in the books of the Swedish CSD.

French law provides that the investor's ownership rights appear in the investor's account in the books of the French intermediary and Swedish law provides that the investor's ownership rights appear in the securities account maintained by the Swedish CSD. However:

a. This is not problematic, neither from the point of view of the treatment of rights flowing from securities; nor from the point of view of the investor protection in case of insolvency of the Swedish CSD, the Swedish account operator or the French intermediary and
b. The proposed Securities Law Directive's approach does not intend to change this in the future.

3. Account-held Securities

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

No, the principles described under "3 – Account-held Securities" would not adequately define the legal position of account holders for various reasons.

First, the term "account-held securities" is not clear. Although we understand from the EU Commission that account-held securities are not a "new category of securities", we do not see why the concept "account-held securities" is necessary in order to achieve the objectives of the future European Legislation. If the objective is to allow the cross-border exercise of the rights enumerated under principle 3.1 (1), p.6, this can be achieved without the use of the terms "account-held securities".

In addition, we fear the introduction of uncertainty:

a. The various national laws apply to the holding of "securities" or "transferable securities" or "financial instruments" or "financial securities". All these terms correspond to the transposition of the MiFID. The superposition of the unexplained term "account-held securities" will lead to a period of interpretation and adaptation, which is not clear for a purpose that is not clearly defined.

b. The MiFID (Directive 2004/39/EC) already contains a classification of Financial Instruments, including transferable securities and Units in collective investment undertakings. The UCITS IV Directive (Directive 2009/65/EC) uses the concepts of transferable securities and transferable instruments. The Geneva Securities Convention uses the terms "Securities" and "Intermediated Securities" – it being understood from the definition of "intermediated securities" in the Convention that they may be a "new category of securities". We fear that the additional concept of "account-held securities" will add uncertainties in the international texts too.

Second, whilst the content of principle 3 addresses the rights of account holders, the title of this principle (and future article of the Securities Law Directive) should be "Rights of account holders". The Geneva Securities Convention's second chapter is entitled "Rights of the account holder" and article 9 provides that "the credit of securities to a securities account confers on the account holder…".

Third, we also think that the term "account holder" should be further clarified in order to distinguish the account holder, who is an intermediary from the account holder who is an investor. This allows:

a. The identification of the person in the chain who takes the decisions related to the rights flowing from the securities (the investor) as opposed to the person who only executes instructions so as to give effect to the investor's decision;

b. The determination of who has ownership rights on the securities (in point 4 of Principle 3.1, the EU Commission provides that national law should be allowed to "characterise the legal nature of account-held securities as any form of property." - we disagree with this, as in a holding chain, most intermediaries do not have any property rights);

c. The determination of who has the right to "acquire" and "dispose" of securities (the terms are not entirely clear and a distinction has to be introduced as per our comments on question 8).

These comments do not touch upon the trust contract, where the legal owner exercises rights but the beneficial owner, who has an equitable interest in the securities, takes the decisions. That relation resulting from the trust contract is out of the scope of the future legislation. The Shareholders Rights Directive is an outstanding example of harmonisation between Common law and the continental European legal systems.

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

The approach proposed by the EU Commission differs from the concepts used in national law. Generally applicable concepts like "account holders" or "account-held securities" are not obvious to be transposed into National laws. The functional approach contains a number of concepts that do not correspond to the national concepts.

The consequences for the business model of our members are mainly related to the risk appreciation. For example, the Financial Collateral Directive contains a distinction, which exists in the legal systems of most Member States, i.e. the distinction between title transfer collateral and security collateral. Although there were differences in the transposition in various Member States, those differences were minimised because of the clarity of the FCD and the concepts it uses. As a result, the transposition of the FCD resulted in an increase in taking collateral and a very positive recalculation of equivalent risk model. We do not expect that there will be increased certainty in the holding and transfer of securities in the EU after the transposition of the Securities Law Directive as it now stands.

We therefore propose:

a. The introduction of a distinction between the account holder, who is an intermediary and the account holder, who is the final investor;
b. The identification of a person who has ownership rights on the securities, without defining the exact legal nature of the ownership rights and without prejudice to the trust contract;
c. The Securities Law Directive should be a legal basis for the operational standards for corporate actions and general meetings, with the purpose of allowing the end investor to exercise the rights;
d. The Securities Law Directive provides that the securities credited to securities accounts maintained by an insolvent intermediary for its account holders never fall within the insolvency estate of an insolvent intermediary;
e. The introduction of methods of acquisition and disposition with title transfer and without title transfer, conform the Financial Collateral Directive. This would introduce great clarity and uniformity in transposition with the FCD.

Q7: *The Geneva Securities Convention (www.unidroit.org/english/conventions/009intermediatedsecurities/main.htm) provides for a global harmonised instrument regarding the substantive law (= content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing this subject. Most EU Member States and the EU itself have participated in the negotiations of this Convention. Both the present approach and the Convention are compatible with each other.*

- *If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?*

- *Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?*

Yes, the business models of our members comprise securities holding or transactions involving non-EU account holders and account providers. Securities accounts are always located in a given country, most often the country where the account provider offers its custody services. The fact that the account holder is non-resident is not relevant for the service provided to him.

Where a non-EU account holder credits securities to a securities account by a EU account holder, the services are subject to the law of the EU Member State where the account provider is located. Vice versa, where a EU account holder credits securities to a securities account by a non-EU account holder, the services are subject to the non-EU law of the State where the account provider is located.

Global compatibility is important. However, within the EU we hope for a form of harmonisation (and not only compatibility), as per the Financial Collateral Directive.

4. Methods for acquisition and disposition

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

1. Integrity. The principles described under "4 – Methods for acquisitions and dispositions", second paragraph, are about integrity of the securities holding chain. As such, the enumerated methods would allow for a framework where no more securities are credited to account holders' securities accounts than had been originally issued by the issuer. However, we would like to make the following comments:
    a. The words "having available" in 4.1(2)(a) are not clear as in the context of a trading account (as opposed to a custody account) the current wording is too wide.
    b. The method provided for in (e) should be applicable only to the CSD, not to any account holder in the chain.
    c. These methods do not guarantee that inflation of securities no longer exists after the transposition of the Securities Law Directive, since they are a high-level enumeration of currently existing methods all over the EU. Avoidance of inflation of securities should be achieved through further national legislation and regulation.
    d. We advocate that integrity is considered statically (securities credited to securities accounts) and not dynamically (settlement process). Temporary (intra-day or less than 24 hours) inflation of securities exists in some jurisdictions. It is not caused by intermediaries over-crediting accounts, but by upper-tier

intermediaries (from an end-investor perspective) over-debiting accounts. This does allow for considerable cost reduction and flexibility in the settlement process.

e. Rules aimed at avoiding securities creation should not prevent legitimate transactions such as securities lending and short-selling.
f. If the Member States have to recognise all of these methods in their national law, that means that they will introduce methods that currently do not exist in specific Member States. For example, methods (c) and (d) do not currently exist in France and method (e) does not currently exist in the United Kingdom. If these countries are obliged to introduce all methods into their national legislations after transposition, there is a risk that leaks in integrity become more important; whereas today, leaks in integrity are related to operational processes, not to legal imperfections.

2. Methods for acquisition and disposition. The drafting currently proposed by the European Commission enumerates within the methods for acquisition and disposition:
    a. Crediting and debiting an account respectively and
    b. Earmarking, control agreement and an agreement with and in favour of an account provider.

    These methods apply to all types of "acquisitions" and "dispositions" no matter what consequences they produce. We advocate that a distinction is introduced between:
    a. Methods, which lead to a transfer of ownership and
    b. Methods, which are used only for taking collateral.

    Such a distinction would conform the Geneva Securities Convention and the Financial Collateral Directive.

    Article 11 of the Geneva Securities Convention provides that "intermediated securities are **acquired** by an account holder by the credit of securities to that account holder's securities account". Article 12 provides that "an account holder **grants an interest** in intermediated securities (…), if [(a) the person to whom the interest is granted is the relevant intermediary; (b) a designating entry in favour of that person has been made; (c) a control agreement in favour of that person applies]."

    The Financial Collateral Directive makes a distinction between a "title transfer financial collateral arrangement", under which "full ownership of financial collateral" is transferred; and a "security financial collateral arrangement", under which a "collateral provider provides financial collateral by way of security".

The Financial Collateral Directive does not govern the manner in which title is transferred and the Securities Law Directive could provide that an "acquisition" (whether that acquisition is a straightforward sale or a title transfer financial collateral arrangement) takes place by debit and credit of securities accounts; while an collateral provider grants an interest, i.e. a security financial collateral arrangement, by earmarking, control agreement or an agreement with and in favour of an account provider.

These issues trace back – to a certain degree - to our consultation response of 2009 in relation to "Legislation on Legal Certainty of Securities Holding and Dispositions":

- The 6 methods described ("Acquisition and disposition of book-entry securities") are not all related to acquisitions and dispositions. Only crediting and debiting an account are such methods.
- The other 4 methods (earmarking, removal of earmarking, control agreement, agreement in favour of account provider) are also desirable methods, not of acquiring or disposing, but of creating some "visibility" for limitations to what is otherwise expected as rights of an account holder. As stated in our earlier consultation response, we are in favour of creating a degree of "publicity" around restrictions or limitations of securities credits, but it is highly questionable whether e.g. earmarking (which is only visible to the account provider) meets this criterion of publicity.
- We urge the Commission to design a functional system with 2 methods of acquisition or disposition (crediting and debiting), and 4 methods of evidencing limitations to securities credits: the consequences to third parties and the visibility to third parties of each of these methods should be clearly set out, inter alia in order to provide compatibility with the FCD, but in no event should the new rules lead to additional formalities.

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

We think that:

a. Member States should not be obliged to integrate all methods into their national legislations;
b. Where a security has been transferred, either with or without title transfer, the transferor may not use that security again. Only the transferee should have the possibility to re-use the security;

c. More detailed national legislation and regulation is necessary, namely to provide for the accountability obligations related to the credit and debit of securities to securities accounts.

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

No comment in the context of this consultation.

5. Legal effectiveness of acquisitions and dispositions

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

a. If the concept of account-held securities has to be transposed into national legal systems, there might be difficulties in transposition and determination of the legal effectiveness of "acquisitions" and "dispositions" of account held securities versus acquisition, disposition and taking security over "securities", "transferable securities", "financial securities" or a "safe custody asset".

b. As per our comments above, the terms "acquisition" and "disposition" under the future Securities Law Directive are not entirely clear, because there is no distinction between "disposition" and "providing security".

c. We have the impression that 2. and 6. in par. 5.1 are contradictory. Point 2 provides that "no further steps (…) should be required to render an acquisition or disposition effective" while point 6 provides that "the effectiveness can be made subject to a condition".

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

The main problems of incompatibilities between the various European markets are related to operations, market practices, non-harmonised settlement cycles and operating hours of settlement systems. Legal differences are less important, especially since the transposition of the Financial Collateral Directive.

6. Effectiveness in insolvency

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

Yes, it does. We would like to make the following observations.

The Financial Collateral Directive and the Settlement Finality Directive provide for "horizontal" insolvency protection rules, i.e., rules respectively between a collateral giver and a collateral taker and between a transferor and transferee of securities. The Securities Law Directive seems to propose a rule on "vertical" insolvency protection rules, although this is not entirely clear in the consultation document.

Client securities are currently well protected under national concepts of ownership, co-ownership and trust. That protection is not effective when account providers improperly credit securities to securities accounts, e.g. where more securities are credited to securities account than the account provider holds upper-tier or where the rights of the account holder on the securities are not clear (ownership or security). We welcome the proposed rules on integrity and a clear definition of a "securities account" (which includes an account provider, an account holder and securities) in the context of protection against the intermediary's insolvency.

We fail to understand the second par. of 6.2, which discusses the situation of the "creditors of the insolvent entity". The investor's protection against the intermediaries' bankruptcy currently results from:

a. Rights of investors on the securities (ownership or equitable interest) and
b. Segregation of proprietary assets from client's assets in the account provider's books.

The reasoning in terms of protection of "creditor of the insolvent entity" is difficult to understand in such circumstances. If the reasoning in terms of "claims" is retained, it must be made clear that the account holders' rights outrank those of *all* insolvent intermediary's creditors, including the secured creditors.

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

No further comment

7. Reversal

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

a. The list of cases is probably not complete as there will always be other cases for reversal (court process, misrepresentation etc.). We assume that references to "Article 9" are reference to the future article on the protection of the good faith acquirer.

b. Case (a) appears to be inappropriate. If both parties agree to a reversal, reversal is possible. This needs not be provided for in the future directive and case (a) could be an open door to general ex ante approvals of reversal for any reasons.

   Currently, reversal is contractually allowed in many custody agreements for reasons set out in the agreement, such as non receipt of payment of the securities credited to the account holder's securities account. Reversal without any other reason than simple consent is never sufficient.

c. We see no repercussions on our members' business model since the cases provided for in principle 7.1 often correspond to cases provided for in custody agreements.

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

For individual members to reply.

8. Protection of acquirers against reversal

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

This rule aims at resolving a potential conflict between the protection of the good-faith acquirer and the reversal of an erroneous crediting. That conflict is resolved in favour of the good faith acquirer unless that acquirer "knew or ought to have known that the crediting should not have been made".

Securities holding chains can be long and operations go fast. If a person benefits from an erroneous crediting and sells the securities onwards to a (real) good faith acquirer, i.e. someone who paid a purchase price, there is a

conflict between (i) that acquirer and (ii) the erroneous crediting to the seller's account. The erroneous credit can be reversed (subparagraph b of rule "reversal of acquisitions and dispositions") while the correct credit can't. This situation can entail an inflation of securities or complicated obligations for intermediaries who have to buy-in the missing securities and claim the costs thereof from the mala fide seller.

The issue can be resolved by deleting the rule (and leaving the matter to be resolved by contract). In our view, the good faith purchaser must be protected above all (in conformity with art. 18 of the Geneva Securities Convention), and if he is protected, "earlier defective entries" (cfr. art. 18.2 of Geneva Securities Convention) may not be reversed.

9. Priority

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

First of all, we would like to observe that principle 9.1(1)(a) ranks 'interests' and not all types of acquisitions and dispositions.

Also, we don't see why "crediting and debiting are not within the scope of the priority provisions"

Account providers need to take collateral. This is because a portfolio of securities is not a static but a dynamic phenomenon. When a custody client wishes to buy or sell securities, the custodian acts as settlement agent. That activity involves entering into an irrevocable commitment to pay or deliver on the settlement date. Accordingly, account providers are making credit available to account holders.

As to principle 9, earmarking and control agreements are not expressly contemplated by the FCD. The collateral taker needs to ensure that there is an indisputable right to seize and sell collateral in the event of a default. There is a risk that introducing new perfection arrangements relating to financial collateral arrangements will lead to additional operational steps, confusion and complication in taking collateral.

Clarification is required as to whether a collateral taker will have to arrange for both earmarking and a control agreement to ensure that priority has been obtained. The provisions do not make it clear what the duties of an account

provider are where securities (or an account) have been earmarked for a particular collateral taker.

Reference is made to our replies to Question 8.

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

There are no significant difficulties reported by our members.

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

No.

10. Protection of account holders in case of insolvency of account provider

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

Yes, a principle where the securities credited to securities accounts are not available in the intermediary's insolvency would protect client securities.

As mentioned above, this is not sufficient. Securities inflation, opacity as to the account holders rights, opacity as to the account provider's identity need to be avoided in order to make this rule effective.

The loss sharing could be left to Member States. However, it seems to us that:

a. The Securities Law Directive should be a directive of minimal harmonisation and
b. The loss sharing methods could be harmonised, as per article 26 of the Geneva Securities Convention.

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

As per our previous comment, the loss sharing rules should be subject to minimal harmonisation.

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

A harmonised rule seems to be in order to the effect that if there is a shortfall in an omnibus account, then the risk of a shortfall should be shared pro rata

(which is the effect of e.g. the FSA Client Money Rules for cash, where a primary pooling event occurs). Segregated clients should not share the burden of a shortfall impacting the accounts of other segregated clients.

11. Instructions

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

Yes. Such a framework for restrictions on whose instructions to follow appears desirable. The principle states clearly under what conditions an intermediary is not bound to give effect to instructions, but there is no positive obligation for intermediaries to give effect to instructions in the ordinary course of business; this may be self-evident, but we encourage the Commission to consider explicitly including such a positive obligation.

12. Attachment by creditors of the account holder

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

Yes.

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

This is a question for our individual members to reply, but we are not aware of any such problems.

13. Attachment by creditors of the account provider

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

Yes.

14. Determination of the applicable law

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

We note that the Conflict of laws rule is to a large extent based on the principle that there is a reasonable expectation of an account holder that the applicable law is the one of the country of the branch through which his account is serviced. However, we take the following position:

We believe that this is a valid criterion for the 'contractual' aspects of a securities account, but this is entirely different for the 'property' aspects of a securities holding, where an account holder should in the first place pay attention to the law of the country of his account provider (irrespective of the branches). This would point to one (as opposed to multiple) legal system for the property aspects, which is in line with WUD whereunder a failing credit institution with branches in other Member States will be subject to a single bankruptcy proceeding initiated in the Member State where the credit institution has its registered office (known as the home State) and will thus be governed by a single bankruptcy law. This approach is consistent with the home country control principle that is the basis for the banking directives.

Translated to the structure of the proposed Principle 14, we therefore favour an approach along the following principles:

a) The place of maintenance of the securities is generally a good connecting factor;
b) When the account provider acts through various branches, the account is deemed to be maintained in the country of the account provider's headquarters;
c) This presumption may be rebutted in either a client communication or a contractual clause stating that the account is maintained in a different country;
d) The rebuttal of this presumption may only be disregarded if there are no relevant connecting factors with the country therein determined.

The background to this approach is explained in more detail, though still very summarily, in our position paper of 30 November 2009, which we attach for your reference.

Q28: Would the mechanism of communicating to the client, whether the head offices or a branch (and if a branch, which one) is handling the

relationship with the client, add to exante clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?

The mechanism of communicating to the client would not contribute to *ex ante* clarity over and above the governing law clause in the account opening documentation. Moreover it constitutes an additional formality. And it might even be misleading as a judge may overrule it on the basis of a fact pattern.
A degree of freedom and flexibility – as described in our reply to Question 27 – would be desirable, and the contract (or account opening document) should settle this issue in a final and decisive way.

Q29: The Hague Securities Convention (www.hcch.net/index_en.php?act=conventions.text&cid=72) provides for a global harmonised instrument regarding the conflict-of-law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed principle 14 differ from the Convention as regards the basic legal mechanism for the identification of the applicable law. However, the scope of principle 14 is the same than the scope of the Convention: property law, collateral, effectiveness, priority. Do you agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, please explain why.

Reference is made to our reply to Question 28.

15. Cross-border recognition of rights attached to securities

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

Yes, as this non-discrimination rule is an key element to successfully dismantle Giovannini Barrier 3. The scope of the non-discrimination rule should encompass all the holding patterns referred to in Recommendations 13a and 13b of the Second Advice of the Legal Certainty Group.
The AFME Post Trade Custody Committee analysed discriminatory practices regarding the cross-border exercise of rights attached to securities in the context of participation in General Meetings (attached).

We therefore take the view that further harmonisation, including specific areas of harmonising company laws, will be required to warrant unhindered cross border exercise of rights attached to securities.

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

Although this is for individual members to reply, the principle of mutual recognition of holding patterns for all types of securities and for all rights attached to securities would, generally speaking, be an important step towards creating a single integrated European securities market.

16. Passing on information

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

In our view the duty to pass on information is adequately kept to the necessary minimum, i.e. limited to those cases where the information is required to enable the exercise of rights attached to securities. However, we propose to distinguish between monetary rights flowing from securities against the issuers (e.g. rights issues) and voting rights (participation in general meetings); in the case of the latter – and only in that space – the ultimate account holder should have the possibility to opt out from receiving the information.

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

We deem the complementary nature of regulation and markets standards important in order to avoid any duplication.

The standards covering end-to-end communication from issuers to end investors are one of the key parts of the Market Standards for Corporate Actions Processing and of the Market Standards for General Meetings, determining the information processes covered by the above principle in greater detail. Therefore, in respect of passing on information – unlike in other areas of corporate actions processing – no further regulatory mechanisms are required.

17. Facilitation of the ultimate account holder's position

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

Yes.

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

Generally yes, always provided that (i) existing discriminatory practices are eliminated and (ii) the holding patterns are recognised as per LCG Recommendations (see answer 30).
Individual members to respond to the question of technical difficulties and cost involved.

18. Non-discriminatory charges

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

We are disappointed by the lack of detail and clarity in the principle. The reality that these charges are (a) a contractual matter, and frequently form part of a bundled rate (where other services are offered simultaneously), and (b) a consequence of the nature of the transactions (e.g. the number of intermediaries involved) seems to be ignored.
Moreover, as stated in our introduction, the proposed regulation of charges levied by an account provider is inopportune as the comparison with the payment area is inappropriate given the continued fragmentation e.g. in the fields of company law and fiscal regimes.

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

N/A. As an industry organisation, we are not an account provider.

19. Holding in and through third countries

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

There are intrinsic practical issues associated with the exercise of rights through non EU-links. It is however doubtful whether any legal obligations (along the lines described in principle 19.1) imposed on account providers would result in increased protection for account holders.

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

This appears to be an issue that is best left to the private sector, where account providers will – as a matter of effective competition – strive for the best possible service to account holders.

20. Exercise by account provider on the basis of contract

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

No. Parties should be free to determine between themselves contractual formalities and service standards which meet the requirements set out by law and any regulation to which they are subject.

21. Account provider status

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

Many account providers are already subject to regulation by virtue of the range of services they provide. Any expansion of regulation should be carefully considered to ensure that it does not inappropriately capture categories of service providers (eg professional persons not involved in regulated activities for example lawyers regulated by their own regulatory bodies) or those providing intra-group services.

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

Further to our response to Q41 above, we would be concerned that the use of MiFID may have unintended consequences. Exceptions and exempt persons would need to be clearly defined. Also if account provision were to become an "investment service" rather than an "ancillary service" as today then this would trigger the application of additional know your customer requirements and other consequences which it is not clear are necessary or the real intention.

This will need to be carefully considered in the current review of MiFID and we intend to reply to any consultation document that the Commission would publish in this context.

22. Glossary

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

a. It is indeed generally a good idea to have legally endorsed definitions of terms used in a particular legal instrument.

b. It is however not clear which definition in the Glossary corresponds to the term “end investor” as used – *inter alia* – in the Market Standards for Corporate Actions Processing.

c. In the definition of "account provider", we suggest deleting the text in square brackets and in italics in the final bullet point.

d. We note that the definition of "legal holder" does not correspond to the terminology used in the shareholders' rights directive (Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies).

e. It appears counterintuitive that the definition of "disposition" includes, beyond disposal, both creation and relinquishing of security interests or other limited interests, and we suggest reserving the term "disposition" for disposal.

Q44: Would you add other definitions to this glossary ?
See our answers to Question 43.

We hope that our replies will assist the Commission in its drafting of the next version of the Securities Law Directive. Please do not hesitate to contact us if any further information of clarification is necessary or desirable. We are prepared and would be honoured to discuss the topics discussed in this document in more detail should you wish to do so.