25 March 2013

Key Proposals for Effective Implementation of Securities Law Legislation

We continue to believe that compulsory harmonisation of member state property law and civil liability regimes may lead to unintended consequences and could increase systemic risk (if credit risk is concentrated in intermediaries) to the ultimate detriment of investor protection. Investors might be exposed to more risk if a prescriptive SLL makes intermediaries more susceptible to failure due to events beyond their control.

To ensure the integrity of the holding chain, we strongly urge maintaining a conceptual framework in which securities are seen as held on a ring-fenced basis from intermediaries so that, as customer property, they are not considered commingled with the assets of the intermediaries to whom they are entrusted. Minimal intervention would be required to align insolvency rules within the Union, providing for the legal segregation of financial instruments belonging to clients and held by custodians, or by CCPs as collateral, subject to any title transfer and security interest arrangements, upon the insolvency of the relevant firm. At the same time, however, we reiterate our recommendation[1] of the recognition of different holding structures (including nominee and omnibus accounts), which continues to be indispensible to the removal of legal barriers and to achieving increased efficiency and cost effectiveness.

In view of these practical considerations and market realities, we propose adhering to an "operational approach" that focuses on harmonisation of operational aspects of securities accounts and transactions. The core of this approach would be that transfer of legal title would be deemed to take effect on the debiting or crediting (as applicable) of an Account Holder's securities account on the books and records of an Account Provider as the overriding principle of a new SLL. We believe that any effects on market practice would be offset by the benefits of a uniform, commonly understood principle underlying all securities transactions, resulting in greater confidence in customer positions in securities accounts. At the same time, a operational approach which is implemented in this way will minimise unnecessary disruption, will maintain legal certainty under the laws of the various member states, will not create impossible burdens to overcome with respect

[1] *See*, AFME Reply to the Consultation Document of the Services of the Directorate-General Internal Market and Services on Legislation on Legal Certainty of Securities Holdings and Dispositions, 31 December 2010, page 3.

to securities held through legal systems outside the EU and will not increase systemic risk through concentration of credit exposure to intermediaries.

More specifically:

- The Securities Law Legislation, should be compatible to the highest degree possible with the Unidroit Convention on Substantive Rules regarding Intermediated Securities (Geneva Securities Convention); however, within Europe we hope for a form of harmonisation that focuses less on making divergent European legal systems compatible for its own sake and more on effective measures to ensure investor protection with minimum disruption to individual legal systems.
- An SLL should apply to transferable securities:
    1. As defined in directive 2004/39/EC, art. 4(18), i.e., securities that are capable of being credited to a securities account (Unidroit art. 1(a));
    2. That are dematerialised or immobilised pursuant to the pending CSD Regulation;
    3. That are held by account providers that safe-keep and administer securities for account holders.
- It should be recognized that legal systems at the national level determine legal requisites of title transfer. Among other divergences, some legal systems involve trust concepts, and some do not. 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 legal title transfer occurs in order to protect investors, i.e.,:
    1. 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;
    2. An Account Provider should undertake to debit or credit an Account Holder's account on the moment 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 undertaken CSD Regulation; and
    3. Account Providers and Account Holders should be able to rely with finality on debits and credits to relevant securities accounts, unless and to the extent necessary to correct an error.
- There should be a clear distinction between (1) 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), and (2) 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. In the former case, the circumstances under which an Account Holder's ownership rights would arise and cease would be clarified. In the latter case, 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 as collateral under a security financial collateral arrangement under the Financial Collateral Directive. AFME believes that the specificities of the manner in which securities may be effectively provided as collateral[2] should be left to national law and the Financial Collateral Directive and, consequently, should be considered beyond the scope of the SLL.

- In relation to collateral it should be made clear that an account holder's creditor may enforce its rights against an account holder only in relation to the securities held by the account holder's relevant intermediary, and not in the books of an upper-tier account provider, including where that account provider holds the debtor's securities in segregated accounts.
- The recognition of different holding structures (including via nominees and intermediaries, whether on a segregated or omnibus account basis), of foreign legal systems, without need of each legal system having 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; however, further steps of harmonisation will be required to enable the unhindered exercise of rights attached to securities.
- In order to retain efficiencies, prevent unnecessary cost and reduce the possibility of error, express provision should be made for use of omnibus accounts with upper tier account providers and settlement systems.
- Whilst the Settlement Finality Directive protects securities settlement in a declared Securities Settlement System against the insolvency of a participant to the system as of the moment of entry of the transaction into the system, nothing addresses settlements in the books intermediaries (i.e. 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 in default.

[2] E.g.,earmarking, removal of earmarking, control agreement, other agreement in favour of an account provider.

- In respect of corporate actions-related requirements, any SLL should be compatible with developing market standards and guidance from market implementation groups.
- In relation to corporate actions, as well as in relation to any instruction for the debit and or credit of a securities account, it must be made clear that the account provider may accept instructions only from the account holder or any person designated for that purpose by the account holder.
- The Legal Certainty Group's recommendations (in particular, recommendation 3) in respect of "core duties" of intermediaries, as set out in its Second Advice and as embodied in the Geneva Securities Convention, Article 10, should be adopted.
- The EU Commission should adopt the legislative form of a Regulation, especially in respect of 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 fields of company law and fiscal regimes.
- The SLL, as a post-trade-orientated measure, should provide for an authorization, supervision and passporting regime that is independent of MiFID and MiFIR, which are entirely inappropriate to post-trade securities settlement considerations. It should clearly delineate whether it applies to market infrastructure providers (such as CSDs and clearing houses (e.g., CCPs)) and their agents. To the extent the SLL 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 SLL.
- Insolvency rules should be harmonised, between Member States, so that there is clear recognition of the segregation of financial instruments held by: (a) a firm for its clients, when acting in a custodial capacity; or (b) a CCP, in respect of client collateral. Minimal intervention would be required to settle a rule that would give greater assurance to investors in the Union 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 acting in a custodial capacity, which is under a legal obligation (whether statutory or contractual) to segregate client financial instruments, has done so. Accordingly, upon the insolvency of the firm, client financial instruments would be available to be returned, irrespective of the legal system under which they are held, in a consistent and certain manner.