Shaping the post-trade industry

PARIS, 18 JANUARY 2011

RESPONSE OF THE

FRENCH ASSOCIATION OF SECURITIES PROFESSIONALS

(AFTI)

TO THE CONSULTATION DOCUMENT

OF THE SERVICES OF THE DIRECTORATE-GENERAL INTERNAL MARKET AND SERVICES

RELATING TO

LEGISLATION ON LEGAL CERTAINTY ON SECURITIES HOLDING AND DISPOSITIONS

Association Française des Professionnels des Titres ("AFTI") is the French association representing the post- trade industry.

All 100 members of AFTI are players in the securities market and back office functions: banks, investment firms, market infrastructures, issuers, in France and more generally in Europe.

<u>PART I – GENERAL COMMENTS</u>

AFTI welcomes the opportunity given by the European Commission to underline the crucial importance of the legal certainty of security holding and disposition since any change to the legal framework governing securities could significantly impact the rights of final investors on securities hold through securities account..

In this respect, if AFTI shares the general objectives consisting to enhance investor protection and to lower the costs of raising capital in Europe compared to other regions, it does not appear that the principles presented in the consultation paper will contribute to strengthen the legal certainty of the transactions within the EU.

At opposite, the recommendations expressed by the European Commission seem to increase the legal uncertainty and could be detrimental to the financial stability and the integrity of the internal market by insufficiently protecting fundamental elements of the security of the financial system, in particular by authorizing mechanisms leading to inflation of securities or putting the rights of the final investors in cause.

In these circumstances, AFTI believes that the primary objective for the European legislator must be to guarantee absolute transparency and safeguard the direct link between the issuer and the final investor, in all circumstances.

The importance of this objective, which is even more significant in the current economic and financial crisis, must necessarily, be represented in a directive that enhances transaction security and protection for the final investor.

To achieve this, AFTI considers that the future Securities Law Directive ("SLD") must encompass at least five main principles. These principles are widely applied throughout the European Union and they tie in with the European Union's political commitment to reinforcing market transparency and protection for end investors.

These five principles are:

1. **The existence of real and direct rights for one person in the chain (often but not always the end investor), who alone holds *in rem* rights in the securities, regardless of the form: ownership, co-ownership, beneficial ownership, etc.** For example, only a final investor acting directly or via a representative can sell the securities – this is not clearly formulated in the Commission's working documents.

This rule protects:

- the final investor, who is the sole owner of the securities,
- preferred creditors,
- the account provider, which cannot be confused with the shareholder.

This in rem right exists currently in all legal systems.

2. **Respect for the *'acquis communautaire'* in terms of conflict of law rules.** Three European directives (the Credit Institutions Winding-up Directive, the Settlement Finality Directive and the Financial Collateral Directive) stipulate that the law applicable to the security is the law of the country where the account is maintained, which is the principle recognised by the text of this consultation . However, the proposed directive includes complicated wording in which securities are sometimes governed by the law of the country in which the intermediary's headquarters are located. Yet the notion of headquarters is not clear, and this is contrary to the "local" logic: the law applicable to the securities is the law of the country where they are recorded in an account.

   The idea of precising the conflict of law rules in that way is not necessary since the European Commission has deemed that the current rule, which is part of the *'acquis communautaire'*, has proven its validity and is applied across the European Union without difficulty.

3. **Refusal of the notions of** "***book-entry securities" or "account-held securities",*** which can give rise to the creation of a distinct asset at each level in the intermediation chain. **Protecting the end investor** requires that the asset credited to an account are securities[1] and not a "book-entry securities", to avoid any inflation of securities and over-voting in shareholders' meetings.

   The future rule governing the effects of recording a security in an account must protect:

   - the final investor, who alone can exercise the rights flowing from the securities,
   - the custodian, which only has an obligation towards the investor and cannot be considered as a shareholder as it has no rights to the securities, and
   - the issuer, which can easily identify its shareholders.

4. The **"no debit without credit"** principle, which is a *fundamental principle* of securities law in all European countries and which protects the integrity of the issue and avoids any inflation of securities. This rule is forbidden by the UNIDROIT Convention, and even in unofficial drafts of the directive that are currently being circulated.

[1] Understood as financial instruments as listed in Annex I section C of directive 2004/39/CE, which are capable of being credited to a securities account.

This principle is necessary as it protects:

- the investor, who will not see his investment disappear or be compromised by the mobilisation of artificial copies of his security,
- the issuer, which retains control over its issue and can identify its shareholders.

5. **The need for issuers to be able to identify their final investors throughout the investment chain, should they so wish.** The future SLD should at least include the shareholder identification principle and a disclosure obligation on intermediaries in this respect, in accordance with domestic rules applicable under corporate law, regardless of whether the shares are held directly or indirectly.

PART II - ANSWER TO THE CONSULTATION PAPER ON LEGISLATION ON LEGAL CERTAINTY OF SECURITIES HOLDING AND DISPOSITIONS

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)?

The future Securities Law Directive should be in line with existing EU legislation. From that perspective, we believe it should build upon the principles which are part of the EU legal corpus currently in effect. As an example the future SLD should use the concepts enshrined in the Financial Collateral Directive including the concepts of “title transfer financial collateral arrangements” and “security financial collateral arrangements” of the Financial Collateral Directive, so that then the concepts “acquisition” and “disposition” of the SLD be consistent with those concepts used in the FCD.

From reading the consultation document, we have the impression that the EU Commission has drafted this document as a stand-alone piece of legislation. However, this would introduce considerable uncertainties.

The existing directives that should be considered for drafting the SLD are at least: the **Financial Collateral Directive, the Shareholders Rights Directive, the Winding up Directive, the Markets in Financial Instruments Directive, the Market Standards for Corporate actions and for General Meetings, the undertaken Investor Compensation Scheme Directive and the Geneva Securities Convention in many aspects.**

First, we would like to express our concern as to the **conflict of law rule**. Although there were no comments on the conflict of law rule made during the revision of the Financial Collateral Directive and the Settlement Finality Directive, the EU Commission proposes to specify the “country” in which the securities account is located. However:

- That “country” should be a Member State of the Union only (which is not clear in the current text of principle 14.1;

- The second sentence of principle 14.1 is unclear as to the applicable law to non-EU domiciled account providers;

- Principle 14.1 (2) leads to increased uncertainties and accounts provider's responsibility, namely in the case of requalification.

We refer to our answers under questions 27 and 28 for this.

Second, 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 has achieved a remarkable level of harmonisation in respect of the methods of taking collateral by distinguishing **title transfer** collateral and **security** collateral.

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. Even the Markets in Financial Instruments Directive relies on the principle that investors have ownership rights in securities. None of the directives governing aspects of securities holding adopted the functional approach.

If the functional approach is retained, it should be far more ambitious, namely by providing that a person in the securities holding chain is investor, legal holder and owner of the securities. This doesn't mean that the form of ownership needs to be harmonised: the ownership, co-ownership and trust regimes should be maintained. They most efficiently protect investors against the insolvency of intermediaries.

Third, we draw the EU Commission's express attention to article 24 of **Directive 2001/24/EC on the reorganisation and winding-up of credit institutions.** That article governs the situation of the enforcement of proprietary rights in "instruments"~~,~~ and has enshrined in EU Community law the *lex rei sitae* principles in this respect. The Securities Law Directive is the right vehicle to determine that a person in the securities holding chain has proprietary rights in the securities. This could be made subject to a declaration mechanism to the EU Commission, where Member States must declare to the EU Commission which securities account in the chain of intermediaries is, according to its national law, the securities account where ownership rights are exercised.

We also draw the EU Commission's attention to the **Investor Compensation Scheme Directive** under consideration, which may oblige account providers to pre-fund a compensation scheme up to an amount of 50 Basis Points (0.5%) of the value of the deposited assets. That would amount to an immobilisation of 27 billion Euros (EFAMA statistics), all over the EU, for UCITS only. **If the proprietary rights in securities and appropriate segregation rules are retained in the SLD, such a huge compensation scheme may no longer be justified. The future Securities Law Directive would usefully contribute to achieve that goal by providing that in the EU, investors have directly or through fiduciary legal structures, a form of proprietary rights on securities (ownership, co-ownership, legal ownership, beneficial ownership, equitable interest...), which therefore:**

- **do not appear on the account provider's balance sheet, and**

- **do not fall within the insolvent intermediary's estate.**

Fourth, the consultation paper takes the view that the future legislation should refrain from harmonising the legal framework governing the question of whom an issuer has to recognise as the **legal holder of its securities** (principles 1.1 (2)). We do not share that view as the **Shareholders Rights Directive** has harmonised the determination of the shareholder (art. 1.2 and 2(b) of Directive 2007/37/EC). This method should be used for all types of securities to be governed by the SLD and the definition of “legal holder” should be adjusted accordingly.

In addition, the future legislation should acknowledge an EU wide identification principle, in order to ensure a more effective identification and disclosure by the intermediary, wherever it is located, of its clients. Please refer to our answer on question 43.

Fifth, **we would like to draw the EU Commission’s attention to the market standards on corporate actions and the market standards on general meetings. The future Securities Law Directive should provide sufficient legal basis for those market standards**. There are difficulties in the cross-border **exercise of rights flowing from securities** held through securities accounts. Those difficulties are most often of a purely operational nature and not of legal nature. Initiatives like T2S and the harmonisation of settlement cycles will further remove barriers.

Legal barriers to the application of those standards exist, and the Securities Law Directive is the appropriate instrument to remove some of those barriers. Two examples of barriers are:

- Electronic communications. The Shareholders Rights Directive, art. 8 provides for the right to participate in the general meeting by electronic means. Secured electronic communication should be extended for the entirety of communications about shareholders‘rights between account holders and account providers throughout the chain of intermediaries.
- The Market Standards for General Meetings refer to “basic custody services”. The proposed SLD does not define those basic custody services. However, a number of obligations for account providers are contemplated under the SLD. A clear and straightforward enumeration of obligations would have our preference, instead of wording of as highly legal-technical nature where the obligations of intermediaries are not clearly defined.

Sixth, concerning the legal framework governing the **holding and disposition of securities** held through securities accounts, there are differences between Member States’ legislations governing the holding and transfer of securities, but those legislations are not a source of legal uncertainty. They are well known and in most cases date from the 1860-ies! We do not believe that it may be sustained that in the EU the cross-border holding and disposition of securities held through securities accounts:

a. suffer from legal uncertainty or that it is often not clear what an investor owns,

b. is ineffective.

Example 1 – transparent and non-transparent systems

A French investor purchasing Swedish Securities credits the securities to a securities account maintained with 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:

- This is not problematic, nor 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
- The proposed Securities Law Directive's approach is not expected to change this in the future.

Seventh, we have a comment on the **integrity of the issuance of the securities.** 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 may result in an important deficiency 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, eventually via registrars).

2 - SHARED FUNCTIONS

Q2: no comment

Q3: 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. We have illustrated this through a practical example (Example 1 under point sixth of this document).

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 three reasons.

The concept “account held securities” is in:

- Consultation document p. 6, Chapter 3 “account held securities”
- Compilation document of September 17, art. 4.

Although reservations have been expressed about the Geneva Securities Convention, that Convention refers to “rights of the account holder rights” (Chapter II of that convention is called “Chapter II – Rights of the account holder”)~~,~~. Therefore, we believe that the future European legislation should govern the rights of account holders.

First, **the term “account-held securities” is not necessary.** 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”.

*Second***, we fear the introduction of legal uncertainty**:

1. **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**. 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.

2. **We fear that the additional concept of “account-held securities” will add uncertainties in the international texts too.** 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 constitute a “new category of securities”.

Third, we further believe that the term “account holder” should be made more precise in order to distinguish the account holder, which is an intermediary from the account holder, who has ownership rights. **Currently, the ownership regimes of the EU Member States efficiently protect investors against intermediaries’ insolvencies**.

In point 4) of Principle 3.1, the EU Commission provides that the national law should be allowed to “characterise the legal nature of account-held securities as any form of property ….” We strongly disagree with this, since in a securities holding chain, most intermediaries do not have any property rights at that level of the holding pattern.

We draw the EU Commission’s express attention to article 24 of Directive 2001/24/EC on the reorganisation and winding up of credit institutions and to the proposed **Investor Compensation Scheme Directive under consideration, as above mentionned[2] which may impose on the account providers the burden to**

[2] See answer for Question 1.

pre-fund a compensation scheme up to an amount of 50 Basis Points (0.5%) of the value of the assets on deposit. That would amount to an immobilisation of 27 billion Euros (EFAMA statistics). **If the proprietary rights in securities and appropriate segregation rules are provided for, such a compensation scheme of such a high order of magnitude is no longer justified. It would be a highly desirable contribution of the future Securities Law Directive to provide that in the EU, investors have directly or through fiduciary legal structures, a form of proprietary right on securities (ownership, co-ownership, legal ownership, beneficial ownership, equitable interest...), and that therefore those assets do not fall within the insolvent intermediary's estate.**

Drafting proposal 1 on "Securities" and "Rights of the account holder".

We propose a redraft of principle 3 along the following lines:

"*Article N - Rights of the account holder*

Member States shall ensure that the credit of securities to a securities account confers on the account holder at least the following rights

[no further change to this article, other than the replacement of the term "account held securities" with the term "securities"]."

In all articles of the SLD, the term "account held securities" needs to be replaced with the term "securities". In some articles, it is clear that the term "securities", in those specific articles, mean certificated securities or dematerialised securities. This is the case for example in article 4.1.where subsection (a) of that article concerns "securities in a securities account", while subsection (d) applies to "relevant securities certificates".

We also propose a "**Whereas**" explaining that from a strictly legal conceptual and theoretical point of view, the "asset" credited to a securities account is not always the security, but a mirror of the security. The following formulation could be retained:

"*The Securities Law Directive does not take position on what constitutes a credit to a securities account, nor on the legal conceptual nature of the credits of securities to securities accounts. Throughout this Directive, the terms "securities are credited to a securities account" are used for convenience and to reflect the usage in the securities industry. This does not mean that this Directive qualifies the credits to a securities account*."

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 strongly from the concepts used in national law. We find difficulties understanding how generally applicable concepts like "account holders" or "account-held securities" can be transposed into National laws. This is in our view susceptible of creating confusion. The proposed approach is fully inconsistent with the European acquis and with national concepts. We firmly believe in the concept of single ownership over one security. There should be no shared ownership over (a security where ownership over one security should be confined to one person).

Example 2 - Equivalent risk appreciation.

The consequences for our business model are mainly related to the risk appreciation. For example, the transposition of the FCD resulted in an increase use **of collateral and a very positive recalculation of equivalent risk models**. 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. 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.

Equivalent risk is the percentage applied to an overdraft in the calculation of the necessary collateral. For example, where an account provider “AP” allows an account holder “AH” an intraday overdraft of 100 to facilitate settlement, AP applies a percentage to that overdraft facility of 100, which allows the calculation of necessary collateral. Since the transposition of the Financial Collateral Directive and the increased certainty in the enforcement of collateral, that percentage has been considerably lowered, allowing the AH to immobilise less collateral.

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, **for the purpose of the application of the Market Standards on General Meetings and on Corporate Actions**;

b. The acknowledgement that only a single person has ownership rights on the securities, without defining the exact legal nature of the ownership rights and without prejudice to the trust contract, **for the purpose of protection against the intermediary’s insolvency**;

c. The introduction of methods of acquisition and disposition with title transfer and without title transfer, which conform to the Financial Collateral Directive. This would introduce greater clarity and uniformity in transposition with the FCD;

Q7: The Geneva Securities Convention provides for a global harmonised instrument regarding the substantive 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 holding 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~~,~~ our business models 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 of no influence on 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. As mentioned above the Geneva Convention does, however, not meet the high standards which we expect the SLD to achieve in terms of investor protection and prevention of systemic risk in particular in respect of treatment of integrity of the issue and availability of sufficiency of securities at each level of the holding chain

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. In principle the methods as such allow for a framework where no more securities are credited to account holders' securities accounts than had been originally issued by the issuer provided appropriate safeguards are introduced in view of the generality of some of the concepts used. We would, indeed, like to make the following comments:

   a. The words "having available" in 4.1(2)(a) are not clear and we favour drafting which provides:

   Drafting proposal 2 on integrity:

   "*having securities credited to its securities accounts, maintained by another account provider*"

   b. The method provided for in (e) should be applicable only to the CSD, not to any account holder in the chain.

   c. We would like to stress the importance of further national legislation and regulation avoiding inflation of securities. **This could be provided in a whereas in the preamble to the future Securities Law Directive.**

   d. We advocate that integrity be considered only 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. This allows for considerable cost reduction and flexibility in the settlement process.

   e. If the Member States have to recognise all 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, to the best of our knowledge, method (e) does not currently exist in the United Kingdom. If these countries are required to introduce these methods into their national legislation after transposition, there is a risk that this may lead to leaks in integrity becoming more important; whereas today leaks in integrity are related to operational processes, not to legal imperfections.

f. We believe that a “no credit without debit” rule should be the better way to ensure the integrity of the issue since in the context of the disposition and acquisition of securities, debiting and crediting should not be considered in isolation as doing so might lead to inflation and, as a consequence, does not guarantee the integrity of the issue.

2. **Methods for acquisition and disposition**. The current drafting proposed by the European Commission contemplates among the methods envisaged for acquisition and disposition:

a. Crediting and debiting of an account respectively and

b. Use of earmarking and control agreements and an agreement with and in favour of an account provider.

The concept “acquisitions and dispositions” are found:

- Consultation document p. 9, Chapter 4 “Methods for acquisitions and dispositions”;

- Compilation document of September 17, art. 5 and 6.

We have noted that even Articles 11 and 12 of the Unidroit Convention contains this distinction, as well as the Financial Collateral Directive.

We advocate that a distinction be introduced between:

a. Methods, which lead to a transfer of ownership and

b. Methods, which are used only for taking security collateral.

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 address the manner in which title is transferred and the Securities Law Directive could provide that an “acquisition” (whether that acquisition is an outright sale or a title transfer financial collateral arrangement) takes place by debit and credit of securities accounts; while a 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.

Proposed redraft on "acquisitions and dispositions"

"*Article N - Methods for acquisitions and dispositions*

Member States shall ensure that securities are acquired by the credit of securities to the acquirer's securities account.

The owner of securities disposes of securities by the debit of securities to his securities account.

A Title Transfer Financial Collateral Arrangement, as defined in Directive 2004/47/EC, may be effected by debit and credit of securities to securities accounts under this article.

*[*To be completed with the necessary caveats on "no impediment on company law" and "reversals*"].*"

"*Article N+1 - Methods for Security Financial Collateral Arrangements*

Member States shall ensure that collateral givers give effect to Security Financial Collateral Arrangements, as defined in Directive 2004/47/EC, or grants a limited interest other than Security Financial Collateral to an Collateral Taker, if:

The Collateral Giver enters into an agreement with or in favour of that person; and

One of the following conditions applies:

- *The collateral taker is the relevant intermediary;*
- *An earmarking in favour of the collateral taker or a beneficiary has been made;*
- *A control agreement in favour of the collateral taker applies.*"

Drafting of article N+1 is inspired by the Financial Collateral Directive.

Like the Unidroit Securities Convention, **a specific section on the integrity of the securities holding chain needs to be inserted.** In the current proposal, this is to be found in the following sub-sections:

- Consultation document p. 9, Chapter 4 "Methods for acquisitions and dispositions", principle 4.1 (2);
- Compilation document of September 17, art. 5(2).

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 of MiFID regulated entities)? Please distinguish between regulating the account provider's behaviour and issues relating to the effectiveness of excess credits made.

We think that:

a. Member States should not be required to integrate all 5 methods into their national legislations;

b. Where a security has been transferred, either with our without title transfer, the transferor may not use that security again. Only the transferee should have the possibility to reuse the security;

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

d. Legislation to be considered should establish different mechanisms of supervision in order to achieve the integrity of each position in securities and book-entry securities, regardless of the size and the presence of cross-border elements in the account provider's chain. So, the legislation must determine a competent, national or European, Supervisory Authority, entitled to monitor and require from intermediaries, auditors and CSD's to issue on a timely basis certificates in order to assure that the right numbers of securities are, from time to time, recorded in each account provider's records.

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

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 would need 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, namely because there is not 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.**

However under the French mandatory dematerialised securities system the ownership concept is such that there can only be one owner to a security and a credit of a security to a security account constitutes evidence of that ownership. There can be no spin-off of different rights in securities through a separate credit to a securities account evidencing different interest.

The proposal tabled by the European Commission, if adopted, would result in a major disruption in the French securities holding pattern and open a path fraught with uncertainty in a domain where under the current legal system in effect there is absolute certainty.

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?

Client securities are currently well protected under the national concepts of ownership, co-ownership and trust. The effectiveness of that protection fails when account providers improperly credit securities to securities accounts, for example where more securities are credited to securities account than the account provider holds upper-tier or where the exact 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 strongly disagree with a reasoning where securities may be assimilated to claims against the intermediary, such as in the second par. of 6.2, which addresses the situation of the "creditors of the insolvent entity". The investor's protection against the intermediaries' bankruptcy currently results from:

a. ***In rem* rights** of investors on the securities (ownership or equitable interest) (See Winding Up Directive) 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 under such circumstances.

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.

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

No further comment.

7 - <u>Reversal</u>

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 of your business model?

The list of cases seems incomplete since the reversal of a simple “**erroneous**” credit is not enumerated. We understand the references to “Article 9” as a reference to the future article on the protection of the good faith acquirer.

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?

Case 7.1.1(a) of the consultation paper 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 in current market practice.

We see repercussions on our business model if national laws provide for the possibility of general consent to reversal without the reasons therefore being explicit since this would allow our sub-custodians to reverse credits without sufficiently clear reasons.

8 - <u>Protection of acquirers against reversal</u>

Q16: Do you agree with the ‘test of innocence’ as proposed (‘knew of 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?

Yes.

9 - <u>Priority</u>

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.

Yes, control agreements would need a inferior priority because they do not appear in the account. We fear that in case of insolvency, the insolvency administrator would need to verify the contracts in order to determine the insolvent intermediary’s estate. This would be done easier and quicker if all types of interests in securities are reflected in the account. A possible caveat may be made in favour of CSDs who (i) exercise the central settlement function and (ii) need control agreements in order to facilitate the settlement process in the system which has been notified under the Settlement Finality Directive.

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 specifically mentioned within the scope of the priority provisions. Although we assume they are within that scope there would be merit in specifically clarifying that point which is material and of utmost importance.

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.

We have not as control agreements are not used nor recognised in France in view of their lack of transparency and enforceability concerns.

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.

See above responses under Q 17.

10 - PROTECTION OF ACCOUNT HOLDERS IN CASE OF INSOLVENCY F THE ACCOUNT PROVIDER

Q20: Would a principle along the lines described above pave the way for the national frameworks to effectively protect client securities in case of 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 should be harmonised.

Contrary to the statement made in the second paragraph of 10.2 we see nothing wrong that securities held by the insolvent account provider for own account be attributed as a matter of priority to shortfalls in respect of client securities. The account provider should indeed have the duty to hold at the upper tier level sufficient securities to cover both client securities and securities for own account. In that respect, he must guarantee the absence of shortfalls and from that perspective we see nothing wrong to allocate own securities to guarantee that obligation whether that feature be characterised as a superpriority in favour of securities accountholders or otherwise. This is a legitimate priority and is far from being unjustified.

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 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?*

See our answer to question 21.

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.

The Principle uses indistinctly the terms "intermediary" and "account provider". We suppose that those terms are synonymous and mean "account provider".

The Principle is correct:

- the account provider should receive instructions only from the account holder *and*
- the account provider must execute the account holder's instructions.

Limitations to these elements of the Principle should be clear. In this respect, sub-paragraphs (a) and (b) seem related to the methods of acquisitions and dispositions. In our view the link should be made clearer so to avoid that the future article governing instructions becomes a tool to deviate from the provisions of the future article on Methods for Security Financial Collateral Arrangements (methods for acquisition and disposition). In respect of paragraph (a) appropriate safeguards should be contemplated to avoid ex ante discretionary blanket authorisations.

We do not see the justification of sub-paragraph (e). This should be either deleted or the reference to an account agreement should be added. As it now stands, an operator of a securities settlement system can be allowed to refuse the execution of an instruction, while the participant to that system is obliged to execute the instruction given by its client.

A rule should be added so as to provide that, failing the end investor's instruction, an upper-tier intermediary (or intermediary of the upper-tier intermediary) may not provide instructions related to the rights flowing from those securities. **If an end investor does not exercise rights, exercise of those rights should lapse and not be exercised by intermediaries.**

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.

It does not because in the national legal systems, the ownership rights (full ownership, co-ownership, legal ownership or beneficial ownership) appear only in one given securities account in the securities holding chain.

A rule, which explicitly prohibits upper-tier attachments, seems appropriate in a legal system where securities are considered as claims against the account provider and therefore appear on several levels of the holding chain per issued security.

Typically, an "upper-tier attachment" could be an attachment of (i) a mirror of the debtor's securities or (ii) third parties' securities. Under current legal practice, this already is inefficient.

We urge the EU Commission to create a declarative system where the Member States notify the EU Commission of the account in the chain where ownership rights appear and which may therefore be attached. For example, in French law, article L211-4 of the Monetary and Financial Code provides that the securities account is opened in the name of the owner of the securities. This is the account where attachments are susceptible of being realised. The other accounts in the chain can only be direct or indirect mirrors of that securities account.

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.

We have not.

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.

We have the same comments as to question 25.

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?

Yes, the Principles described in the Consultation document under chapter 14 allow for a consistent conflict-of-law regime and we welcome the EU Commission's proposal.

However, the second sentence of Principle 14.1 provides: "*Where an account provider has branches located in jurisdictions different from the head offices' jurisdiction, the account is maintained by the branch which handles the relationship with the account holder in relation to the securities account, otherwise by the head office.*" This sentence is not clear – the terms lacking clarity are underscored. One possible interpretation is that:

(i) If the account provider is located (through a branch or headquarter) in a Member State of the EU, the applicable law is the law of the Member State where the account provider is located;

(ii) “Otherwise”, *i.e.* if the account provider has no presence in the EU, the applicable law is the law of the headquarter.

This interpretation is in accordance with the definition of account providers. An entity qualifies as ‘account provider’ also when it is “not subject to the law of a Member State”. This is also in conformity with the use of the word “jurisdiction” in this sentence – while the compilation document of September 17 used the word “Member State”.

We strongly disagree with such an interpretation and since we do not see the benefits of this second sentence, we propose to delete it from the future legislation.

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 ex ante 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?

No, it would lead to two types of uncertainties, both related to the **risk of requalification** exists.

(i) One the one hand, an account holder can in good faith believe the indication provided by the account provider and an erroneous law would be applied to the account;

(ii) On the other hand, we fear that an account provider who provides erroneous information would be held responsible for providing information inconsistent with reality of facts.

Q29: *The Hague Securities Convention 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 differs 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.*

Yes it will. The Financial Collateral Directive already brought great clarity in this respect. The fact that legal systems differ from each other is not a source of legal uncertainty, as long as the legal systems are known. The United States has introduced a consensus-based conflict of law rule into their legal system in 1994 which meets US concerns. This US approach has never proved problematic with regard the conflict of law rules of the Settlement Finality Directive, the Financial Collateral Directive and the Winding Up Directive.

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?

While the need from a practical perspective for introduction of such principle across all European jurisdictions has in our view not been established, it would in any case be appropriate at least to ensure that account holders can act as account providers for other account providers and/or account holders across Europe in such a manner that investors are in a position to exercise their rights without undue impediment. Difficulties are indeed encountered with the exercise of voting rights, the use of securities as collateral, tax issues, or exercise of shareholder rights, etc.

Recent experience has shown that holders of beneficial or economic interests in Madoff related matters have encountered difficulties to have their position recognised to act in that capacity (through denial of standing in court or otherwise). Similar problems have been encountered in Lehman related matters (attempts to entangle the web of various interests has contributed to delays in distribution and allocation of rights in Lehman related matters).

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

Despite higher costs, the overall consequences would be foremost positive.

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.

This obligation is already provided for in the market standards for general meetings and in the market standards for corporate actions. As it currently stands, it seems too general. The specifically identified legal obstacles to the implementation to those markets standards should be provided for in the future Securities Law Directive.

It should be noted that as a matter of priority passing on of information has its roots in company law and there can be no substitute to the principles set in company law.

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?

The Joint Working Group General Meetings and the Joint Working Group Corporate Actions have both achieved an outstanding set of standards, which have been endorsed by all constituencies. Gap analyses are in the course of being realised. We strongly encourage the EU Commission to follow those gap analyses, which will identify the legal barriers to the implementation of the Market Standards.

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.

As indicated above, the roots of the rights of investors lie in company law and there can be no substitute thereto as far as fundamental recognition of shareholder rights is concerned. The role of account providers can only be to facilitate the process set under company law.

We do not share the comments made in paragraph 17.2 according to which it would be difficult or cumbersome to identify or trace ultimate investors. French corporate law contains such mechanism and its implementation does not raise particular difficulties.

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, the cross-border exercise of rights is believed to work sufficiently well. Practical problems only arise with regard to the exercise of voting rights in a General Meeting, where information provided by the issuer reaches investors too late or in foreign language. To this end, the Joint Working Group on General Meetings (JWGGM) has developed Market Standards to harmonise General Meeting related operational processes in Europe.

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 document seems to ignore the reality that these charges are in essence a contractual matter, and that they frequently form part of a bundled rate (where other services are offered simultaneously).

We also don’t see how such a principle may be enforced or otherwise implemented. For example, where a French account provider has a French domiciled account holder depositing an given amount of securities and an Italian domiciled account holder depositing a lot less securities, there will be differences in prices, but they are related to the size of the deposits, not to the country of domiciliation of the account holders. In other words, how to isolate the various reasons for which account providers would apply different prices to their account holders.

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?

We do not price differently.

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.

Despite cross-border holding of securities being subject to international technical market standards, difficulties are encountered in certain jurisdictions regarding (among others) the operational aspects, extra costs, delays, non assumption of obligations to allow the exercise of rights flowing from the securities.

The provision deserves further clarification. It is not clear under which regime an account provider would become liable when he has made all reasonable and appropriate arrangements with its foreign account holder, who subsequently fails to satisfy the principles outlined in this proposal for a directive. Moreover, the terms 'reasonable' and 'appropriate' give little explanation as to the requirements of EU-based account providers.

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?

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.

Any provision to that effect should be subject to the principle set under civil law according to which ownership rights need to be protected. Contractual provisions may not derogate from such principles in such a manner as to deprive the owner of exercise of its ownership rights.

21 - ACCOUNT PROVIDER STATUS

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

Yes

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

Yes

22 - GLOSSARY

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

Yes, we find the glossary helpful.

We would like to draw the EU Commissions special attention to the definition of "*account provider*", which now allows non-EU based and non-EU regulated account providers to qualify as account providers under the proposed SLD. We are in favour of the deletion of the second part of the definition of "account provider", which is currently in square brackets.

The definition of "account provider" should be amended as follow:

(c) 'account provider' means a person who: – maintains securities accounts for account holders and is authorized in accordance with Article 5 of Directive 2004/39/EC to provide services listed in Annex I Section A indent (9) of Directive 2004/39/EC or is a Central Securities Depository as defined in […] and, in either case, is acting in that capacity; ~~*– [in relation to Principles 3 to 13, if not subject to a national law, in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;]*~~

The definition of "legal holder" should be made more precise, so to be in line with the definition of "shareholder" under the Shareholders Rights Directive.

It is unclear whether the "end investor" of the Market Standards for General Meetings and for Corporate Actions corresponds to the Ultimate Account Holder or to the Legal Holder. Our understanding is that neither of those terms always designates the end investor. It also means that the proposed SLD contains no definition of the end investor.

Q44: Would you add other definitions to this glossary ?

Yes, a definition of end investor and use of that term throughout the articles of the proposed SLD on corporate actions processing so to align the SLD with the Market Standards on Corporate Actions and on General Meetings.

A F E P

Association Française des Entreprises Privées

POSITION OF THE French BANKING AND ISSUERS WORKING GROUP ON THE PROPOSED SECURITIES LAW DIRECTIVE (SLD)

14.01.2011

I . CONTEXT

In view of the European Commission's current work to finalise the draft Securities Law Directive (SLD), the main associations representing the French banking and financial community[1] and the issuers[2] have set up a financial sector working group. The purpose of this working group is to express in this document their observations, on the content of the working documents[3] currently being discussed by the Commission and Member States.

The proposed Securities Law Directive is a major part of ongoing reforms of the international securities legal framework, which is covered by two draft conventions, namely the Hague Securities Convention (2002) and the Geneva Convention (Unidroit) on Substantive Rules for Intermediated Securities (2002-2009).

At a European level, the European Commission set up a group of experts, named the Legal Certainty Group (LCG), to draw a common work and reflection on this subject. Their work widely pre-dated the financial crisis. An informal SLD group involving representatives of Member States was recently set up by the European Commission with a view to drawing up a directive on intermediated securities. In this context, the French financial sector considers to be of fundamental importance to take into account the failures identified during the financial crisis, as illustrated by the collapse of Lehman Brothers.

1 AFG, AFTI, AMAFI, FBF (associations representing banking and financial market professionals).

2 AFEP, ANSA, MEDEF (associations representing private companies, issuers and employers).

3 Discussion papers n°1 to 8 of the European Commiss ion, the « *Member States Working Group Updated Compilation of the rules and explanatory notes discussed so far* » dated 17 September 2010 and the consultation document date 5 November 2010.

II. THE IMPLICATIONS OF SECURITIES LAW

A) Economic and social issues

The draft SLD is of crucial importance to the French financial sector. **The French securities intermediation and custody business is the largest in Europe and ranks number two worldwide, behind the United States (see the rankings at 31 March 2010 in Annex 1).**

Assets administered by French securities account providers worldwide **amount to over EUR 13,000 billion**.

This French specificity generates over 95,000 jobs and contributes significantly to the European Union's competitiveness and attractiveness. The three largest French providers are present in over twenty member states, making securities intermediation a leading European industry[4].

Any change to the legal framework governing securities could significantly impact the profitability of the European intermediation industry and thereby affect the organisation and jobs in the companies concerned.

B) Financial market transparency and protection for European investors

The future SLD is a major challenge with significant implications for European issuers and investors (individuals and institutions) alike. The text could have direct consequences on European legal systems governing the holding of financial securities, which for the most part[5]:

- **guarantee the integrity of securities issues** (by ensuring there is no risk of inflation of securities leading to over-voting in shareholders' meetings, or of shares being lost since the number of shares held in accounts by an intermediary on behalf of its clients is equal to the number of shares it holds with a sub-custodian);
- **guarantee investors' rights in respect of securities** (ownership or co-ownership rights, trusts), even in the event of default by one of the intermediaries in the investment chain. **Recognition of investors' rights regarding their shares is the bedrock underpinning the direct relationship between an issuer and its investors.** These rights must be exclusively reserved for the owner of the shares, as this exclusivity is an integral part of the relationship between the investor and the issuer (except where mandates are used), and their relationship with the account provider (protection in the event of collapse of the custodian);
- **offer a real protection to intermediaries**, in particular in the event of default by a client or counterparty (this protection was significantly enhanced by the

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4 In Europe these countries are: Austria, Belgium, Cyprus, Croatia, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain, Switzerland, United Kingdom, Serbia, Russia, Bulgaria, Slovenia and Romania. Outside France, French custodians are present in Hong Kong, Morocco, Singapore, Turkey, Canada, Bermuda, USA, Egypt, South Africa, India and China.

5 Germany, France, United Kingdom, Italy, Spain.

Financial Collateral Directive), thereby contributing to maintaining market liquidity.

III. GOALS AND GUIDELINES PROPOSED BY THE FRENCH FINANCIAL SECTOR

In these circumstances, the French financial sector believes that the primary objective for the European legislator must be **to guarantee absolute transparency and safeguard the direct link between the issuer and the final investor, in all circumstances**.

The importance of this objective, which is even more significant in the current economic and financial crisis, must necessarily, be represented in a directive that enhances transaction security and protection for the final investor.

To achieve this, the French financial sector believes that the future SLD must encompass at least five main principles. These principles are widely applied throughout the European Union and they tie in with the European Union's political commitment to reinforcing market transparency and protection for end investors.

These five principles are:

1. **The existence of real and direct rights for the final investor, who alone holds rights over the securities, regardless of the form: ownership, co-ownership, beneficial ownership, etc.** For example, only a final investor acting directly or via a representative can sell the securities – this is not clearly formulated in the Commission's working documents.

   This rule protects:

   - the final investor, who is the sole owner of the securities,
   - preferred creditors,
   - the account provider, which cannot be confused with the shareholder.

This real right must not be compromised by incompatible legal systems.

2. **Respect for the *'acquis communautaire'* in terms of conflict of law rules.** Three European directives (the Credit Institutions Winding-up Directive, the Settlement Finality Directive and the Financial Collateral Directive) stipulate that the law applicable to the security is the law of the country where the account is maintained, which is the principle recognised by the text of this consultation. However, the proposed directive includes complicated wording advocating that securities are sometimes governed by the law of the country in which the intermediary's headquarters are located. Yet the notion of headquarters is not clear, and this is contrary to the "local" logic: the law applicable to the securities is the law of the country where they are recorded in an account.

   The idea of precising the conflict of law rules in that way is not necessary since the European Commission has deemed that the current rule, which is part of the *'acquis communautaire'*, has proven its validity and is applied across the European Union without difficulty.

3. **Refusal of the notions of** "***book-entry securities" or "account-held securities",*** which can give rise to the creation of a distinct asset at each

level in the intermediation chain. **Protecting the end investor** requires that the asset credited to an account are securities[6] and not a "book-entry securities", to avoid any inflation of securities and over-voting in shareholders' meetings.

The future rule governing the effects of recording a security in an account must protect:

- the final investor, who alone can exercise the rights flowing from the securities,
- the custodian, which only has an obligation towards the investor and cannot be considered as a shareholder as it has no rights to the securities, and
- the issuer, which can easily identify its shareholders.

4. The **"no debit without credit"** principle, which is a *fundamental principle* of securities law in all European countries and which protects the integrity of the issue and avoids any inflation of securities. This rule is forbidden by the UNIDROIT Convention, and even in unofficial drafts of the directive that are currently being circulated.

This principle is necessary as it protects:

- the investor, who will not see his investment disappear or be compromised by the mobilisation of artificial copies of his security,
- the issuer, which retains control over its issue and can identify its shareholders.

5. **The need for issuers to be able to identify their final investors throughout the investment chain, should they so wish.** The future SLD should at least include the shareholder identification principle and a disclosure obligation on intermediaries in this respect, in accordance with domestic rules applicable under corporate law, regardless of whether the shares are held directly or indirectly.

oOo

6 Understood as financial instruments as listed in Annex I section C of directive 2004/39/CE, which are capable of being credited to a securities account.

ANNEX I – Global ranking of custodians

Ranking of the world's 10 largest custodians by assets under custody (AUC).

Source: globalcustody.net, 31/03/2010

Ranking	Company	AUC in USD billion	Nationality	Date
1	BNY Mellon	22,300	USA	31/12/2009
2	JP Morgan	13,500	USA	31/03/2009
3	State Street	13,260	USA	30/09/2009
4	Citi	11,068	USA	30/06/2009
5	**BNP Paribas Securities Services**	**5,793**	**France**	**31/12/2009**
6	**Société Générale Securities Services**	**4,491**	**France**	**31/12/2009**
7	HSBC Securities Services	4,400	UK	30/06/2009
8	Northern Trust	3,600	USA	30/09
9	**Caceis**	**3,300**	**France**	**31/12/2009**
10	UBS	3,044	Switzerland	31/12/2009

ANNEX II – Additional back-ground information

I. **Background.** In 1994, the USA have revised article 8 of the UCC "Investment Securities", with the purpose of facilitating the collateralisation of broker's securities in favour of investment banks. The 1994 reform introduced the "**indirect holding system**", which implies that the securities issued by the issuer exist as a registration into the issuers register in the name of DTCC and that the securities held by intermediaries and investors are a distinct asset, called "**securities entitlement**". That asset is a "bundle of rights", mainly claims of the account holder (client) on the intermediary. Whether the account holder is an end investor or an intermediary, he always receives a "securities entitlement". The purpose of facilitating collateralisation is achieved: a superposition of securities entitlements corresponds to each issued security. The difficulties are related to **opacity:** the issuer has no means of knowing its shareholder base (legally, DTCC is a shareholder); and to **leaks in integrity:** the inflation of securities is important, leading namely to over-voting. This is caused by the fact that a lender of securities is allowed <u>not</u> to debit the lent securities from its securities account, and the borrower still credits them to his account, thus leading to inflation of securities.

This system implies less burdensome legal and accounting obligations for intermediaries (no double sided accounting, which implies the compulsory debit of one account and corresponding credit of another account) and less counterparty risk (in case of insolvency of an intermediary, his clients are outranked by the insolvent intermediary's secured creditors – namely collateralised investment banks and brokers).

In addition, where a US global custodian holds foreign (non-US) securities, he supports the differences between American law (applicable between the global custodian and its client) and the local law (applicable between the global custodian and its foreign sub-custodian).

Since the 1994 reform of article 8 of the UCC, two major international texts have been finalised. Both are inspired by American law. (1) The **2006 Hague Securities Convention** on the law applicable to securities (negotiations were finalised in 2002). This Convention allows parties to an account agreement to decide which law applies to the effects of the credit of securities to a securities account for third parties, practically leading to the application of American law each time a US custodian is an account provider. (2) The **2009 Geneva (Unidroit) Securities Convention on intermediated securities** (minimal harmonisation of securities holding and transfers) introduces the concept of "intermediated securities" into domestic securities law. Similarly to the American "Securities Entitlement", its content is a bundle of rights of an account holder against an account provider.

The Harmonisation of European securities law on the American model profits US custodians, whose operations and accounting are already based on American law. The legal risk resulting from the holding of foreign securities also disappears. These elements are of utmost importance in the custody industry, which is currently under pressure with cost – income ratios exceeding 80%.

II. **Procedure of adoption of the European Securities Law Directive.** After the finalisation of The Hague Securities Convention, the adoption of it was discussed between the European Commission and the Member States. It was decided that the EU would not sign The Hague Securities Convention among others for reasons of incompatibility with the "*acquis communautaire*". Three EU Directives provide that the law applicable to the securities is the law of the country where the securities account is maintained. The rationale of this rule is the transparency and certainty for third parties.

Since the finalisation of the Geneva Securities Convention, the adoption of it is not discussed between the European Commission and Member States. Instead, the EU Commission has drafted a text, which is strongly inspired both by the Geneva Securities Convention and by American law. Despite its apparent legal neutrality, the underlying economical rationale is a global harmonisation by aligning the future European securities regime on the American model.

In order to achieve that purpose, the European Commission created an "informal" working group chaired by the Commission and composed of representatives of Member States. It meets every month, before publication of the impact assessment and before adoption of the text in co-decision.