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THE DEVELOPING EU LEGAL FRAMEWORK FOR CLEARING AND SETTLEMENT OF FINANCIAL INSTRUMENTS

by Klaus M. Löber

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by Klaus M. Löber [2]

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Abstract

Traditionally, clearing and settlement of financial instruments has not been the focus of general attention, even though it is at the heart of any financial system. The ongoing integration of financial markets, and in particular the process of creating a single market for financial services in the European Union (EU), has put in the spotlight the importance of clearing and settlement. Weaknesses in the clearing and settlement infrastructure can have serious consequences for the financial sector as a whole. In view of this, the European Commission has given high priority to removing the barriers to efficient cross-border clearing and settlement in the single market. Clearing and settlement depends to a large extent on the legal infrastructure on which it is built. Clear and effective legal rules are a prerequisite for building market confidence, fostering investor protection and limiting and managing systemic risk. A modern and efficient legal framework in the EU will not only enhance the safety, soundness and efficiency of the clearing and settlement of financial instruments, it will also promote the further integration and competitiveness of European financial markets.

This paper presents and evaluates the existing EU legislative framework. Furthermore, the paper describes current EU initiatives to remove barriers to efficient clearing and settlement, with a specific focus on the legal aspects and, in particular, on the activities of the Legal Certainty Group. Finally, it compares the European initiatives with parallel efforts to harmonise laws on a global scale and gives an outlook as to how the *acquis communautaire* could evolve in the short to medium term.

'Legal issues have been identified as one of the fundamental barriers to making cross-border clearing and settlement as efficient, safe and cost-effective as it is at national level.'[1]

I. INTRODUCTION

The ongoing integration of financial markets, and in particular the process of creating a single market for financial services in the European Union (EU), has put in the spotlight the importance of efficient clearing and settlement for a properly functioning financial system.

In modern securities markets, it has become common practice for securities no longer to be held in physical form by investors. Sophisticated structures have been developed to allow for the holding and transfer of securities without physical handling. Under such structures, one or more specialised entities, which may be called 'intermediaries'[2], are interposed between the issuer of the securities and the investor. These intermediaries maintain securities accounts in which positions in respect of securities are recorded. Commercially and economically, credits and debits to securities accounts ('book-entries') are treated as being equivalent to the physical holding of securities. However, legally the status of these book-entries and of the rights they confer differ across countries.

In most countries, a further category of entities, central securities depositories (CSDs), is involved in the holding structure. CSDs serve as the point of entry, enabling book-entry holding and transfer of securities. This process may vary, depending on the jurisdiction. Either securities are issued directly in a CSD in dematerialised form (i.e. through an electronic record), or securities that have been issued as certificates (in the form of individual certificates or through a global note representing the entire issue) are deposited with a CSD and subsequently immobilised (in a sense that they are permanently held by the CSD and are not circulated) or dematerialised (i.e. converted into electronic records). Irrespective of whether securities are immobilised or dematerialised, the subsequent holding and transfer of the positions of investors is made exclusively by book-entries on securities accounts at all levels in a chain of holding.

In many countries the emergence of intermediated holding structures entailed the need to adapt substantive national laws to cater for the resulting new legal issues. Securities, company and property laws were frequently still based on the assumption of the physical possession of

[1] Internal Market and Services Commissioner Charlie McCreevy, on the occasion of the establishment of the Commission's Legal Certainty Group, 1 February 2005.

[2] The term 'intermediary' does not equate entirely to a generally accepted function or group of entities. Other terms are used such as 'custodian' or 'account provider', depending on the context or the jurisdiction. In the following, unless otherwise stated, 'intermediary' is used as a synonym for the neutral expression 'account provider'.

certificates by an investor or, at best, the safekeeping of an investor's holdings with a depository bank[3].

Notwithstanding these legal questions, intermediated holding structures based on book-entries have become instrumental in carrying out the quick and effective transfer of a very large number of securities following transactions concluded in the various domestic financial markets, which in the past would have involved the physical movement of paper certificates. Once a transaction has been concluded, for example a trade on a stock exchange, a repurchase or a securities lending arrangement, the subsequent processes are usually referred to as *clearing and settlement* or more generally *post-trading activities*.

Functionally speaking[4], *clearing* covers all activities from the time a transaction involving securities is made until it is finally settled. This may include, for instance, the transmission, reconciliation and, in some cases, confirmation of transfer orders prior to settlement, possibly including the calculation of net positions[5] and the establishment of final positions for settlement. In short, it ensures that all the prerequisites for settlement are in place.

Clearing functions may be undertaken by specialist clearing houses. The process of clearing may also involve a central counterparty (CCP), which is interposed between the counterparties to trades, acting as the buyer to every seller and the seller to every buyer. Through the involvement of CCPs, market participants only bear the standard credit risk of the CCP, and not that of individual market participants.

Finally, *settlement* is the process whereby titles to securities or interests in securities are transferred, usually against payment, to fulfil contractual obligations such as those arising from securities transactions on stock exchanges. To the extent that a securities transfer is linked to a simultaneous payment, the underlying mechanism is called 'delivery versus payment' or DvP.

In respect of international bonds and Eurobonds, two further entities should be mentioned; Clearstream Banking Luxembourg and Euroclear Bank Brussels, also jointly referred to as

3 Cf. Kanda, 'Legal issues relating to indirectly held investment securities in Japan', *The Japanese Annual of International Law* 2003, p. 46.

4 It is acknowledged that what is considered as being covered by definitions of clearing and settlement differ from country to country and from source to source. The terms used here are meant to be understood in the widest possible sense. For those interested in more elaborate definitions, reference is made to the Glossary of the European Monetary Institute publication 'Payment Systems in the European Union' (the Blue Book), April 1996, http://www.ecb.int/pub/pdf/othemi/bluebook1996en.pdf; the Glossary of the Report of the BIS Committee on Payment and Settlement Systems, 'Payment and Settlement Systems in selected countries' (the Red Book), April 2003, http://www.bis.org/publ/cpss53p17.pdf; or the European Commission's 'Report on Definitions' (Salvatore Lo Giudice) in context of the work of CESAME, October 2005, http://europa.eu.int/comm/internal_market/financial-markets/docs/cesame/ecdocs/20051024_definitions_en.pdf.

5 This may involve the netting of obligations, including netting by novation (the substitution of old obligations by new ones). Cf. Partsch, 'Analysis of the current legal framework for clearing and settlement services in the European Union', *Euredia* 2005, p. 15, p. 26 et seq.

‘international central securities depositories’ (ICSDs)[6], which settle trades in international and national securities, usually through direct or indirect (through local agents) links to local CSDs. Whereas both Clearstream Banking Luxembourg and Euroclear Bank operate with a banking licence, few national CSDs have banking status[7].

Traditionally, clearing and settlement procedures have not been the focus of general attention, even though they are at the heart of any financial system, and if they have any weaknesses this can have serious consequences for the financial sector as a whole. If clearing and settlement entails too many risks, or if it is too costly or too complex, financial transactions will be discouraged.

The safety of clearing and settlement depends on the soundness of the legal infrastructure on which they are built. The relevant areas of law are complex and sometimes obscure, widely considered to be an ‘esoteric but vital area of law’[8]. Until recently, market participants were often not aware of the degree of legal complexity that may arise from the differences in national laws applying to securities. The risks associated with legal certainty were rarely acknowledged or accommodated in a financial transaction. This was partly because of the parties’ belief that they would be effectively insulated from such considerations by using local intermediaries for transferring and/or holding securities. Market participants usually only became aware of the risk when a problem in enforcing their positions in respect of securities arose.

However, with the steady rise in the number of cross-border transactions, growing reliance on collateral, and increasing international competition, market participants and public authorities have become increasingly aware of the relevance of legal and operational barriers to the seamless conduct of transactions in financial instruments, both across-borders and domestically.

This is true, in particular, for the financial markets in the EU, where a single market for financial services has been under construction since 1973. Initially, the EU focused on the provision of a secure prudential environment for the cross-border activities of financial institutions, whereas the financial markets themselves remained mostly fragmented. However, since the introduction of the euro, the pace of development has quickened. As a direct result of the changeover to the euro in 1999, the creation of a single money market was achieved in

6 Idem., p. 24 et seq.

7 For instance the German CSD Clearstream Banking Frankfurt and OeKB in Austria.

8 Commission press release: ‘Commission granted authority to negotiate international convention on holding securities’, 20 December 2005.

those EU Member States that adopted the euro as the single currency[9], marking an important step towards a fully integrated single market for financial services in the EU.

However, the same degree of integration has not yet been realised for the cross-border circulation of financial instruments, where the advent of a truly pan-European market is still hampered by legal and operational barriers. To some extent, changes induced by market participants are already being made, with the consolidation of providers of securities clearing and settlement services as a prominent example. Yet, to reap the full benefits of these changes in a further reduction of costs and efficient allocation of resources, there is a need for a sound and effective legislative and supervisory framework to support and facilitate such integration. Such development is of particular interest not only for market participants, but also for the conduct of the single monetary policy of the Eurosystem, which must be implemented consistently throughout the euro area. The more integrated the financial markets become, the more homogeneous will be the performance and the effects of the Eurosystem's single monetary policy[10].

It is widely acknowledged that any attempt to remove the existing barriers, particularly in the field of clearing and settlement, will be a highly complex task. Such an effort will have to balance a number of sometimes conflicting principles. Given the sophistication of the EU financial markets, no proposal aimed at promoting financial integration can start with a clean sheet. It has to take into account the legal traditions of the Member States as well as established domestic and international market practices. While complying with the fundamental principles of legal certainty and transparency, an improved framework will also have to gain the confidence of market players and investors alike. This will require balancing the demands for market efficiency and the need for adequate investor protection. The EU principle of an open market economy with free competition will have to be met in parallel with the responsibility for safeguarding financial market stability.

As regards the harmonisation of the underlying legal framework, the above issues are intensified by the intrinsic connection between these substantive law issues and domestic concepts of property law and company law, which are closely guarded prerogatives of any country. Yet, some measures to harmonise certain legal effects may be unavoidable if legal uncertainties and risks are to be removed. In the context of securities clearing and settlement, the absence of a harmonised legal regime for holding and transferring financial instruments, in particular when using such assets as collateral, has been identified by market participants as

9 Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. Subsequently, Greece adopted the Euro in 2001. Denmark, Sweden, the United Kingdom and the ten new Member States (cf. footnote 12) have not yet adopted the single currency.

10 Sáinz de Vicuña, 'Optional Instruments for the integration of the European Financial Markets', *Liber amicorum Paolo Zamboni*, 2005, p. 397, p. 398.

one of the most critical obstacles to further integration and to making cross-border clearing and settlement as efficient, safe and cost-effective as it is at national level[11]. The existing degree of diversity of legal systems could give rise to distortions and it affects market liquidity. This situation has become even more acute since the latest enlargement of the EU on 1 May 2004, with ten new countries and hence, ten new jurisdictions joining[12]. The continuing enlargement process, with further countries applying to join the EU, will add to the pressure to try to resolve these issues.

In response to these challenges, the EU has intensified its efforts towards the further integration of EU financial markets[13], in which the clearing and settlement infrastructure has grown to become a core element.

II. FINANCIAL INTEGRATION AND THE EMERGING EU LEGAL FRAMEWORK

The EU only started to legislate for the clearing and settlement of financial instruments, and the use of such assets as collateral, at a relatively late stage. The first major legal act in this field, Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems (the 'Settlement Finality Directive')[14], was only adopted in 1998. Since then, activity has increased, with Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the 'Collateral Directive')[15] being the most prominent result. Building on this, the Commission has recently embarked on a new, far-reaching initiative to increase the efficiency of cross-border clearing and settlement in the EU[16].

Community legislators have at times been criticised for acting without an overall plan, only addressing specific points of concern and trying to resolve these on a case-by-case basis (*pointillism*)[17]. However, the legislative powers given to the EU by the Treaty establishing the European Community (the 'EC Treaty') are circumscribed by the principles of limited powers, subsidiarity and proportionality[18]. In accordance with its main task of establishing a common market, the Community is bound to pursue the activities of establishing and

[11] Cf. the report of the Giovannini Group, 'Cross-border Clearing and Settlement Arrangements in the European Union', Brussels, November 2001, p. 54 et seq.; or the report of the European Financial Markets Lawyers Group, 'Harmonisation of the legal framework for rights evidenced by book-entry securities in respect of certain financial instruments in the European Union', June 2003.

[12] Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.

[13] Cf. Commission Communication of 11 May 1999 on implementing the framework for financial markets: action plan (COM(1999) 232 final), and related progress reports, (http://www.Europa.eu.int/comm/internal_market/finances/actionplan/index_en.htm).

[14] OJ L 166, 11.6.1998, p. 45.

[15] OJ L 168, 27.6.2002, p. 43.

[16] Commission Communication of 28 May 2002 on Clearing and settlement in the European Union – Main policy issues and future challenges, (COM(2002) 257 final); and Commission Communication of 28 April 2004 on Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final). (http://Europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm).

[17] Cf. C. Keller, 'Die Wertpapiersicherheit im Gemeinschaftsrecht', *Bank- und Kapitalmarktrecht* (BKR) 2002, p. 347, p. 348.

[18] Cf. EC Treaty, Article 5.

safeguarding the freedom to provide (financial) services and removing restrictions on the movement of capital and payments within the EU subject to these basic principles[19].

Within this overall frame, since 1999 the legislative initiatives in the field of collateral, clearing and settlement have been dominated by the implementation of the Financial Services Action Plan (FSAP), which is an ambitious project aimed at achieving a truly integrated market for financial services in the EU.

(a) The Financial Services Action Plan

This initiative is the Community's response to a perceived lack of integration of the European wholesale and retail financial markets, and of the absence of a legislative strategy to deal with new challenges in the financial sector, including close cooperation between the competent supervisory authorities[20].

In June 1998, the Cardiff European Council invited the European Commission

> 'to table a framework for action ... to improve the single market in financial services'[21].

In response to this mandate, in October 1998, the Commission published a Communication[22] identifying a range of issues and calling for urgent action to secure the full benefits of the single currency and the optimal functioning of the European financial markets.

The ensuing discussions between the Member States and the Commission led to the launch of the Financial Services Action Plan (FSAP) by the Commission in May 1999[23], which was subsequently endorsed by the Cologne Council in June 1999. The project was given the highest priority by the Lisbon Council of March 2000[24], and in order to accelerate the completion of the internal market for financial services, it requested a tight timetable should be set for the FSAP to be implemented by 2005. The FSAP had three main goals, which can be summarised as the creation of (i) a single EU wholesale market, (ii) open and secure retail markets, and (iii) sound prudential rules, within the overall objective of minimising costs for capital and financial intermediation. Specific emphasis was put on prioritising measures relating to wholesale financial markets and the call for their accelerated implementation reflects the importance of the contribution of this market sector to economic growth.

[19] Cf. EC Treaty Articles, 2 and 3.
[20] Commission Communication of 28 October 1998 on Financial services: building a framework for action, (COM(1998) 625 final).
[21] Pt. 17, Presidency Conclusion, Cardiff European Council (15/16 June 1998).
[22] Commission Communication of 28 October 1998 on Financial services: building a framework for action, (COM(1998) 625, final).
[23] Commission Communication of 11 May 1999 on implementing the framework for financial markets: action plan, (COM(1999) 232 final).
[24] Pt. 21, Presidency Conclusions, Lisbon European Council (March 2000).

The priorities within the wholesale market sector have had a strong focus on regulating the issuance and trading of financial instruments, on the creation of common rules for an integrated securities and derivatives market, and on the raising of capital on an EU-wide basis. Here, the Directive on Markets in Financial Instruments of 21 April 2004[25] is one of the most important measures adopted so far. It replaces the regime established by the Investment Services Directive in 1993[26]. One of its main aims is to widen the scope of investment services by means of a 'European passport'. It allows investment firms, banks and exchanges to provide their services across borders on the basis of their home country authorisation, and enhances investor protection rules by including effective mechanisms for real-time cooperation between supervisors. Other important measures in this regard are the introduction, by the revision of the Prospectus Directive[27], of a single passport for issuers, allowing for the approval of a prospectus for the issuance of securities by the authority in one Member State to be accepted in all Member States, and the setting out of the disclosure requirements for issuers of listed securities in the Transparency Directive[28]. The Regulation on the application of international accounting standards (IAS)[29] requires all publicly traded companies to apply the same set of standards for the preparation of their consolidated accounts.

In contrast to issuance and trading, the clearing and settlement of financial instruments, and the use of such instruments as collateral, is reflected in the FSAP by only two priority measures, namely the preparation and adoption of the Collateral Directive to provide legal certainty for the (cross-border) use of collateral, and the completion of the implementation of the Settlement Finality Directive to protect crucial clearing and settlement systems against systemic risk. The subsequent main clearing and settlement initiative was not part of the

[25] Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1).

[26] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, (OJ L 141, 11.6.1993, p. 27).

[27] Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, (OJ L 345, 31.12.2003, p. 64).

[28] Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, (OJ L 390, 31.12.2004, p. 38).

[29] Regulation (EC) No 1606/2002 of 19 July 2002 on the application of international accounting standards, (OJ L 243, 11.9.2002, p. 1), see also Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (OJ L 261, 13.10.2003, p. 1); Commission Regulation (EC) No 707/2004 of 6 April 2004 amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (OJ L 111, 17.04.2004, p. 3) and Directive 2003/51/EC of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings (OJ L 178, 17.07.2003, p. 16).

original FSAP; it was only launched in 2002[30], and thus could not be finalised by the FSAP deadline of 2005.

Overall, the FSAP is considered to be a major success. Of the 42 original FSAP measures, 39 had been successfully[31] adopted by the target date set by the Heads of State or Government[32]. The period following the completion of the FSAP ('post-FSAP') is characterised by the implementation and enforcement of the adopted FSAP measures. However, the need for several new post-FSAP measures has been identified, including measures on the clearing and settlement of securities[33].

(b) The Comitology procedure

The FSAP has been instrumental in improving EU legislation in the area of financial services. However, the smooth functioning of an EU-wide financial market requires the consistent implementation of EU legal acts and effective cooperation between European supervisors. Moreover, in order to keep pace with developments in the financial markets, the regulatory and supervisory structures need to be adjusted correspondingly.

In July 2000, the EU Economic and Financial Affairs Council (ECOFIN) appointed a group of 'Wise Men' to investigate the issue and propose solutions. The seven-member group was chaired by Baron Alexandre Lamfalussy, former president of the European Monetary Institute.

After an initial report, which was released in November 2000, the group published its final report (the *Lamfalussy Report*)[34] in February 2001. This recommended the reform of the EU regulatory structure for the securities markets. This call for reform was based on the finding that the development of European securities markets was being hindered by a plethora of interconnected factors and barriers such as: the absence of clear, EU-wide regulation (e.g. on prospectuses, cross-border collateral, market abuse, and investment service provision) which was preventing the implementation of a mutual recognition system; an inefficient regulatory system; inconsistent implementation, due in part to the lack of agreed interpretation of the existing rules; differences between legal systems (e.g. on bankruptcy proceedings, effective judicial procedures, etc.); differences in taxation (e.g. withholding taxes, the imposition of stamp duty or different taxation rates applied to equities and government bonds, etc.); political barriers (e.g. miscellaneous and creative techniques to protect national markets or

30 Cf. footnote 16.

31 Cf. Commission press release: 'Financial Services Action Plan: good progress but real impact depends on good implementation', 1 June 2004.

32 Lisbon European Council of 23-24 March 2000, reconfirmed by consecutive European Councils, including the Brussels European Council of 20-21 March 2003.

33 Address by A. Schaub, 'The Financial Services Action Plan: Evaluation and Future', 8 December 2004.

34 Final Report of the Committee of Wise Men of 15 February 2001 on the Regulation of European Securities Markets (http://Europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm).

products favouring local suppliers); external trade barriers (e.g. the non-authorisation of EU trading screens in certain countries outside the EU); and last but not least, cultural barriers.

The major obstacle was seen as being the current regulatory framework, which was considered: too slow (e.g. the Take-over Directive[35] had been discussed for twelve years); too rigid and not able to react speedily enough to changing market conditions; producing too much ambiguity; and failing to distinguish core, enduring and essential framework principles from practical, day-to-day implementing rules[36].

In response to this, the Lamfalussy Report proposed the application of the comitology procedure, which is a legislative apparatus which should be capable of dealing with new legislative challenges and consists of four layers of intervention.

At Level 1, there are framework principles in the form of legislative acts (directives or regulations) proposed by the Commission following consultation with all interested parties, and adopted by the Council and the European Parliament under the 'co-decision' procedure, in accordance with the Treaty. In adopting each Directive or Regulation, the Council and the Parliament agree, on the basis of a Commission proposal, on the nature and extent of the detailed technical implementing measures to be decided at Level 2.

At Level 2, the European Securities Committee (ESC), consisting of high-level representatives of the Member States, assists the Commission in adopting the relevant implementing measures. Such measures are intended to ensure that technical provisions can keep pace with market developments.

Level 3 measures are aimed at improving the common and uniform implementation of Level 1 and 2 acts in the Member States, through enhanced cooperation and networking between securities regulators. The Committee of European Securities Regulators (CESR), made up of representatives of the competent national supervisory authorities, has particular responsibility for this.

Finally, at Level 4, the Commission strengthens the enforcement of Community law.

35 Directive 2004/25/EC of 21 April 2004 on takeover bids (OJ L 142, 30.4.2004, p. 12).

36 To some degree, this stems from the fact that the main legal instruments used by the Community legislator are directives, i.e. legal acts which require incorporation by the Member States into their national legislation. This process often leads to ambiguous or diverging national implementations of Community directives.

This four-level approach was endorsed by the European Council at Stockholm in March 2001[37], and the relevant committees were established in July 2001[38]. Since then, a number of key measures under the FSAP have been adopted by following the comitology procedure (the Market Abuse Directive[39], the Prospectus Directive[40], the Markets in Financial Instruments Directive[41] and the Transparency Directive[42]).

Similarly, any new legislative initiatives in the field of securities will be able to profit from the new regulatory procedure, which has since been expanded to include the banking and insurance sector. Enhanced cooperation between supervisors and the focus on enforcement by the Commission is intended to improve the regulatory consistency of the EU and deepen the financial integration of the financial markets.

III. CURRENT EU LEGISLATION

The instruments that make up the EU legislative framework for collateral, clearing and settlement do not constitute a single comprehensive framework, covering the full range of activities and functions. Nor do they cover all the types of institutions that are involved in such activities, particularly as many actors in the financial markets have recently begun to expand the range of their activities in these sectors.

The main existing EU legislation in this area is the Settlement Finality Directive[43] of 1998 and the Collateral Directive[44] of 2002. Further relevant provisions can be found in the Markets in Financial Instruments Directive of 2004[45], which replaced the Investment Services Directive of 1993[46]. To some extent, specific provisions on solvency ratios in the Banking

37 The full text of the Resolution of the Stockholm European Council may be viewed at: http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.%20ann-r1.en1.html.

38 See Commission Decision 2001/527/EC of 6 June 2001 establishing the Committee of European Securities Regulators (OJ L 191, 13.7.2001, p. 43), amended by Commission Decision 2004/7/EC of 5 November 2003 (OJ L 3, 7.1.2004, p 32), and Commission Decision 2001/528/EC of 6 June 2001 establishing the European Securities Committee (OJ L 191, 13.7.2001, p. 45), amended by Commission Decision 2004/8/EC of 5 November 2003 (OJ L 3, 7.1.2004, p. 33).

39 Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), (OJ L 96, 12.4.2003, p. 16.

40 Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, (OJ L 345, 31.12.2003, p. 64).

41 Directive 2004/39/EC of 21 April 2004 on markets in financial instruments, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1).

42 Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, (OJ L 390, 31.12.2004, p. 38).

43 Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems, (OJ L 166, 11.6.1998, p. 45).

44 Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements, (OJ L 168, 27.6.2002, p. 43).

45 Directive 2004/39/EC of 21 April 2004 on markets in financial instruments, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4 2004, p. 1).

46 Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, (OJ L 141, 11.6.1993, p. 27).

Directive[47] and the Capital Adequacy Directive (93/6/EEC)[48] are also relevant. Finally, some of the provisions of the Winding-up Directive for credit institutions of 2001[49] and the Insolvency Regulation of 2000[50] have a bearing on collateral arrangements.

(a) The Settlement Finality Directive

The Settlement Finality Directive of 1998 was the Community's legislative response to the concerns about systemic risk identified in a report published by the Committee on Payment and Securities Systems (CPSS) under the auspices of the Bank for International Settlements. Having identified the main risks associated with participation in a system as credit risk, liquidity risk, operational risk and legal risk, all contributing to systemic risk[51], the CPSS defined legal risk as:

> 'the risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks' [52].

The CPSS considered that legal risk not only has a national dimension (for example, with regard to netting schemes, netting be must be given effect under national law, including upon the opening of insolvency proceedings against domestic participants), but also a cross-border dimension (mainly through the participation of foreign participants in a system). In view of this cross-border dimension, the CPSS concluded that legal risk can only be effectively addressed through the harmonisation of relevant national laws, both the substantive (or primary) rules and the rules of private international law, with a view to increasing certainty as regards the applicable law.

In the cross-border context, the CPSS identified the pivotal importance of the concept of finality, which it defined as follows:

> 'Finality or final transfer is a concept that defines when payment, settlement and related obligations are discharged. A final transfer is an irrevocable and unconditional transfer which effects a discharge of the obligation to make the transfer.'[53]

47 Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, (OJ L 126, 26.5.2000, p. 1).

48 Directive 93/6/EEC of 15 March 1993 on capital adequacy of investments firms and credit institutions, (OJ L 141, 11.6.1993, p. 1).

49 Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, (OJ L 125, 5.5.2001, p. 15).

50 Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings, (OJ L 160, 30.6.2000, p. 1).

51 These risks were identified in the specific context of interbank netting arrangements. Cf. No 4, Report of the Committee on 'Interbank Netting Schemes' of the central banks of the Group of Ten countries (Lamfalussy Report), November 1990, http://www.bis.org/publ/cpss04.htm.

52 'Core Principles for Systematically Important Payment Systems', January 2001, report of the Committee on Payment and Settlement Systems, p. 7.

53 Also: 'Finality is important because when it occurs – which depends upon applicable rules and laws – the interbank obligations generated in the interbank payment, clearing and settlement process are discharged. Thus, the credit, liquidity and systemic risks generated in this process, particularly interbank risks, may similarly be extinguished', cf. Articles 3.3 and 3.4 of 'Central bank payment and settlement services with respect to cross-border and multi-currency transactions', a report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries, September 1993, http://www.bis.org/publ/cpss07.htm.

The Settlement Finality Directive was drafted with these considerations in mind. In its recitals, the Settlement Finality Directive clearly identifies as its aims: (i) the reduction of systemic risk linked to payment and securities settlement systems, (ii) the protection of systems and their participants against the effects of insolvency proceedings against a participant in a system (in particular foreign participants), and (iii) certainty as to the law applicable to the rights and obligations relating to securities used as collateral in connection with securities settlement systems or central banks.

With the Settlement Finality Directive, the Community stepped away from its traditional legislative approach to establish mutual recognition and introduced the harmonisation of certain rules of substantive insolvency law, international insolvency law and private international law[54].

The Directive has a rather narrow personal scope of application, being limited to qualifying payment and securities settlement systems. Originally, it was drafted only with payment systems in mind, but it was later extended to cover securities settlement systems as well, due to the 'close connection between such systems and payment systems'[55]. For the purpose of the Settlement Finality Directive, a 'system' is defined as a formal arrangement between three (exceptionally two) or more participants with common rules and standardised arrangements for the execution of transfer orders (for payment or securities transfers) between the participants, governed by the law of a Member State ('chosen by the participants') and designated and notified to the Commission[56] by the Member State whose law is applicable. Pursuant to Article 2(a), a Member State may designate and notify a system within the meaning of the Directive to the Commission, when that Member State is satisfied as to the adequacy of the rules of the system. Systems that are notified and designated enjoy privileged legal treatment throughout the EU which is not available to other systems, custodians or intermediaries. A further limitation of the scope of the Directive stems from the definition of 'participant', which only includes supervised financial institutions, public entities, central counterparties, clearing houses and settlement agents. This limitation was mainly prompted by a reluctance to create extensive exemptions from the application of general insolvency rules.

For systems that comply with the above requirements, the Settlement Finality Directive establishes a regime under which the finality of transfer orders and netting, as well as the

54 Cf. Vereecken/Nijenhuis, *Settlement finality in the European Union: The EU directive and its implementation in selected jurisdictions*, 2005; Devos, 'La Directive Européenne du 19 Mai 1998', *Euredia* 1999, p. 150; and Partsch, 'Analysis of the current legal framework for clearing and settlement services in the European Union', *Euredia* 2005, pp. 15 and 40.

55 Cf. Recital 2 of the Settlement Finality Directive.

56 Settlement Finality Directive, Articles 2(a) and 10. A list of designated systems may be found under http://Europa.eu.int/comm/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm.

enforceability of collateral security, are ensured vis-à-vis both domestic and foreign participants.

In this regard, the two pivotal rules of the Settlement Finality Directive are Article 3, which stipulates the irrevocability and finality of payment orders and netting of transfer orders[57], even in the event of insolvency proceedings (in derogation from otherwise applicable insolvency rules, which would allow transactions performed before the bankruptcy to be reversed or made void); and Article 8, which provides for the application of the law of the system to the rights and obligations arising from, or in connection with, the participation of a foreign insolvent participant (in derogation from otherwise applicable principles of private international law, under which the effects of a participant's bankruptcy are usually governed by the laws of the country under which that participant is incorporated).

Given that the main impetus for the Settlement Finality Directive was the desire to ensure *finality* within systems, it seems surprising that the Directive does not expressly contain the term 'final' at all. Rather, the desired effect is achieved by a combination of three elements. First, it is stipulated that, once entered into a system,

> 'transfer orders and netting shall be legally enforceable and, even in the event of insolvency proceedings against a participant, shall be binding on third parties'[58].

Second, there is the abolition of retroactive effects of the opening of insolvency proceedings (*zero hour rules*) [59]. Third, transfer orders are made irrevocable, as defined by the system's rules[60]. The concept of finality applied by the Directive is thus narrower than the original understanding in the CPSS reports, as it only protects transfer orders and netting, but does not extend to the underlying transactions. Such wide scope of finality protection was not seen being necessary to ensure the process of settlement within the system. As a result, however, underlying transactions are still at risk of invalidation as a consequence of fraud (as expressly referred to in Recital 13 of the Directive) or even under normal insolvency rules[61].

To contain systemic risks, the Settlement Finality Directive therefore provides for the binding effect and enforceability of a transfer order or a netting arrangement, despite the opening of insolvency proceedings against a (domestic or foreign) participant. In principle the system is protected against the possible application of foreign insolvency law under Article 8, which allocates all issues of relevance within a given system to the (insolvency) law governing the system. This leads to the avoidance of conflicts between the legal rules of different

57 As regards the scope of 'netting', cf. e.g. Devos, 'La Directive Européenne du 19 Mai 1998', *Euredia* 1999, p. 150 and p. 172 et seq.
58 Settlement Finality Directive, Article 3.
59 Settlement Finality Directive, Article 7.
60 Settlement Finality Directive, Article 5.
61 Cf. for instance *Hosni Tayeb* v *HSBC Bank plc* (2004) EWHC 1529 (Comm) (Colman J 5/7/2004).

jurisdictions, since all aspects of the system will be governed by the law of the system. However, the success of this mechanism is conditional upon the proper designation of one law for the whole system, insulation against any foreign law, and the irrevocability and finality of transfer orders and netting.

Furthermore, Article 9(1) of the Settlement Finality Directive contains a wide-ranging privilege for all kinds of collateral provided to a participant in a system or to a central bank, as it provides for full ring-fencing against the effects of insolvency proceedings.

Lastly, Article 9(2) of the Settlement Finality Directive contains a conflict-of-laws provision regarding collateral provided to a central bank or a participant in a system. The applicable law is that of the place of the relevant account[62] (*lex conto sitae*); in other words, the applicable law is determined according to the objective location of the account or register in which the right of the collateral taker is entered.

The Settlement Finality Directive, which was required to be implemented by the Member States by 11 December 1999, has made a significant contribution to the reduction of systemic risk within designated EU payment and securities settlement systems[63]. On 15 December 2005, the Commission published an evaluation report on the Settlement Finality Directive[64], as required by Article 12 of the Directive, which specifies that the Commission must present a report on the Directive to the European Parliament and, where appropriate, propose revisions to it. The report was originally due in 2002, however, in view of the enlargement of the EU and the obligation of the new Member States to implement the Directive by 1 May 2004, it was decided to postpone the exercise until implementation had taken place in all 25 Member States. The Commission had already published a review of the transposition of the Directive by the Member States[65], prepared by an external consultancy firm, which concluded that all Member States[66] had complied in their implementations of the Directive, with a few exceptions that were considered unlikely to be significant in practice.

This review, however, was made without prejudice to the formal transposition report, which builds on Member States' replies to a comprehensive questionnaire, as well as the comments of the European Central Bank (ECB) on the Directive. The report concludes that generally, the Directive is seen to be functioning well and the Member States are satisfied with its effect. It finds that the Directive increases protection against risks, and establishes legal certainty and predictability for both domestic and cross-border system participants. However, given recent technical developments and increasing levels of cross-border activity, the Commission

62 This is an expression which is less susceptible to misunderstanding than the term often used: the 'place of the relevant intermediary approach' or PRIMA.

63 Cf. Pitt, 'Improving the legal basis for settlement finality', *JIBFL* 2003, p. 341.

64 http://europa.eu.int/comm/internal_market/financial-markets/settlement/index_en.htm.

65 http://Europa.eu.int/comm/internal_market/financial-markets/settlement/dir-98-26-transposition_en.htm.

considers that there may be a need to improve and clarify the Directive, to ensure that the law keeps pace with changes in the financial markets.

The report identifies ten main issues that should be studied in order to see whether the functioning of the Directive could be improved. These issues include complex questions such as the optimal number of jurisdictions that may apply within a particular system, and the possible conflict of insolvency laws where the law governing a system is different from the law of the Member State where the system is located. It also specifies a number of technical issues such as: the clarification of certain definitions ('arrangement', 'insolvency proceedings', 'participant' and 'indirect participant'); the treatment of electronic money institutions as defined in Directive 2000/46/EC[67]; the clarification of the moment of entry of a transfer order into a system and the scope of 'collateral security'[68]; and an obligation to give direct notification to the ECB and the Commission in the event of an insolvency, given their respective roles as overseer and system operator and as holder of the Community register of systems, respectively.

The Commission has expressed its intention to consult the Member States, the financial services industry and the ECB on these issues in the course of 2006. This consultation process will take into account the important changes in the area of payment and securities settlement systems, which could have an influence on the Settlement Finality Directive. While the Directive was an adequate response to the risks to systemic stability, as they were perceived in the 1990s, since then the environment in which systems operate has changed considerably. Due to cross-border mergers, consolidation and increased cross-border participation, systems may be exposed to a much higher degree of multi-jurisdictionality than was the case when systems were mostly domestic operations. Furthermore, the role of clearing houses and central counterparties has become increasingly important. This could warrant ideas about introducing provisions in the Directive to cater for the specific risks inherent in clearing or cross-border systems, in addition to providing clarity on those concepts used in the Directive which have given rise to diverging interpretations.

(b) The Collateral Directive

The second legal act which is relevant in this context is the Collateral Directive[69]. Collateral is the provision of assets to secure the performance of an obligation, whereby there can either be transfer of the full ownership of the assets from a collateral provider to a collateral taker (e.g.

66 Except for Northern Ireland in the UK.

67 Directive 2000/46/EC of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, (OJ L 275, 27.10.2000, p. 39).

68 In particular in view of the changes announced to the Eurosystem collateral framework (the 'Single List'), which will include bank loans as eligible collateral. Cf. e.g. ECB press release of 30 May 2005, 'First step towards the introduction of the single list of collateral provided for in the revised version of the "General Documentation', http://www.ecb.int/press/pr/date/2005/html/pr050530.en.html.

under a repurchase or transfer of title arrangement) or the giving of rights over assets (e.g. pledge, charge or lien), where the ownership of the assets remains with the collateral provider[70]. Collateral is of particular importance in financial markets. The number and volume of transactions based on collateral is rising steadily. Creditors obtaining valid and enforceable collateral can reduce their credit risks and free credit lines for further business. Collateral is used throughout the EU in all types of transactions, including capital market transactions, bank treasury and funding, payment and clearing systems, and general bank lending. One of the most prominent examples is the EU repo market which has been growing rapidly, particularly following the introduction of the euro and EU enlargement in May 2004. The repo market is now estimated to be in excess of EUR 5.3 trillion[71]. Collateral is also the main tool for reducing systemic risk in payment and securities settlement systems. The collateral is most often provided in the form of cash or securities, namely government bonds or high quality corporate bonds or other securities, in certificated, immobilised or dematerialised form, and frequently held in or through accounts with custodians and clearing systems.

Yet, as shown by various market studies, before the advent of the Collateral Directive the laws and practices on collateralisation differed considerably between the EU Member States[72]. The failure of laws on collateral in the EU to provide an acceptable minimum standard of *ex ante* certainty, particularly for cross-border transactions resulted in costs and delays, as creditors were forced to obtain legal opinions on a case-by-case basis. In contrast to purely domestic situations (where the legal background is usually known and the law chosen normally coincides with the applicable insolvency laws), in a cross-border transaction the laws of different Member States may apply to different parts of a transaction. For example, the assets provided by a debtor may be situated in one Member State, the debt may be governed by the law of another Member State, and the debtor may be incorporated in a third Member State. The cross-border use of securities, together with the international nature of institutions participating in the financial markets, make it increasingly difficult to identify which Member State's laws apply to which parts of the transaction.

It should be noted that the Settlement Finality Directive already expressly protects specific collateral arrangements. However, the Directive only applies to the provision of collateral in connection with participation in a designated system or to a central bank[73]. In response to this,

69 Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements, (OJ L 168, 27.6.2002, p. 43).
70 Cf. also the definitions in the Collateral Directive in Art. 2(1) (a) to (c).
71 Source: ICMA repo market survey, http://www.icma-group.org/content/surveys/repo.html.
72 Cf. International Swaps and Derivatives Association (ISDA), 'Collateral arrangements in EU financial markets', March 2000; European Financial Markets Lawyers Group (EFMLG), 'Proposal for an EU directive on collateralisation', June 2000, www.efmlg.org.
73 Cf. Settlement Finality Directive, Art. 9(1).

the Commission decided to take wider legislative action in the context of the FSAP, namely the preparation and adoption of the Collateral Directive. The financial sector has welcomed this as a helpful measure that cuts out layers of confusing, complex and costly bureaucracy in collateral-taking[74].

Two elements are notable in this respect: first, the Collateral Directive was prepared within an extremely short timeframe; and second, the process was characterised by the strong involvement of market participants. A 'Forum Group' of market experts advised the Commission on the problems inherent in cross-border collateralisation before the Commission submitted its first draft proposal for a directive on 30 March 2001[75]. It then took just one year of discussion in a Council working group and the European Parliament to reach a Common Position. The Collateral Directive was adopted on 6 June 2002 and entered into force on 27 June 2002[76], giving the Member States until 27 December 2003 to implement it[77]. The ten new Member States had to implement the Collateral Directive by the date of their accession[78], i.e. by 1 May 2004. Only two of the old Member States[79] implemented the Collateral Directive by the deadline. The new Member States showed a higher degree of compliance, with more than half implementing the Collateral Directive before their accession to the EU. Although the implementation process was slow and marked by sometimes heated debates, by the end of 2005 all 25 EU Member States had finally implemented the Collateral Directive[80].

The Collateral Directive is evidence of a paradigm shift in Community legislation. Unlike many earlier harmonisation efforts in the single market, it focuses less on the principles of minimum harmonisation and mutual recognition, and concentrates instead on full harmonisation of substantive rules.

The Collateral Directive pursues a number of complementary aims, all converging on the intention to create clear, effective and simple regimes for financial collateral arrangements. According to its recitals, the aims of the Collateral Directive are: first, the removal of the major obstacles to the (cross-border) use of collateral; second, the limitation of administrative

74 Cf. for instance ECB Opinion CON/2001/13 of 13 June 2001 at the request of the Council of the European Union concerning a proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements, (OJ C 196, 12.7.2001, p. 10), in particular at paragraph 4; and the EFMLG statement on a proposal for a Directive on financial collateral arrangements, http://www.efmlg.org/Docs/efmlg_statement.pdf.

75 OJ C 180 E, 26.6.2001, p. 312.

76 Collateral Directive, Article 12.

77 Collateral Directive, Article 11.

78 The same obligation applies to future accession countries.

79 Austria and the UK.

80 For details, cf. Löber/Klima, 'Directive 2002/47/EC on financial collateral arrangements and its implementation by the European Union Member States', *JIBLR* March 2006. As regards the Directive and its background, see also Keller, 'Die Wertpapiersicherheit im Gemeinschaftsrecht', *BKR* 2002, p. 347; Devos, 'The Directive 2002/47/EC on 'Financial Collateral Arrangements of June 6, 2002', *Melanges en hommage à Jean-Victor Louis*, 2003. p. 258; Obermüller/Hartenfels, 'Finanzsicherheiten', *BKR* 2004, p. 440; and Löber, 'Die EG-Richtlinie über Finanzsicherheiten', *BKR* 2002, p. 601.

burdens, formalities and cumbersome procedures; and third, the creation of a clear and simple legal framework.

As regards its personal scope of application, the Directive applies to the parties to a collateral transaction (collateral taker and collateral provider) who belong to one of the following categories: public sector bodies (excluding publicly guaranteed undertakings), central banks and international financial institutions, supervised financial institutions, central counterparties, settlement agents and clearing houses. A further category (whose inclusion may be opted out of by Member States) consists of companies[81], provided the other party is one of the entities referred to above. The limited personal scope of the Directive is the result of a compromise between the advocates of stable and efficient financial market transactions based on collateral, and those who were concerned about the erosion of the principle of the equality of creditors (*paritas creditorum*). The option to exclude companies also gives rise to concerns about the possibility of divergent application of the Directive by the Member States. Indeed, the implementation of the personal scope varies widely between Member States as to the potential parties to financial collateral arrangements who can benefit under the new regime. However, of the 25 Member States, only Austria has used a full opt-out under Article 1(3) of the Collateral Directive. Ten Member States have included within the scope of their implementations persons other than natural persons, unincorporated firms and partnerships, provided that the other party is an institution as defined in Article 1(2)(a) to (d)[82]. All other Member States have chosen a personal scope which either provides for more nuanced limitations[83] or for a wider application[84] than foreseen in the Collateral Directive. Even a combination of both elements has been applied, for instance, in Germany.

Compared with its narrow personal scope, the material scope of application of the Directive is rather wide. It covers financial collateral in the form of financial instruments[85] and cash. The material scope of the Directive also contains an opt-out clause[86] allowing Member States to exclude arrangements where the financial collateral consists of the collateral provider's own shares, or shares in affiliated undertakings. However, only few Member States have made use of this opt-out. The Directive also applies to the creation of collateral under arrangements

81 Defined as 'a person other than a natural person, including unincorporated firms and partnerships', cf. Collateral Directive, Article 1(2)(e).

82 These are Greece (however, it is unclear whether unincorporated firms are covered by the Greek implementation), Ireland, Cyprus, Latvia, Lithuania, Hungary, Malta, the Netherlands, Poland, Portugal and Slovakia.

83 These are the Czech Republic, France, Slovenia and Sweden.

84 These are Belgium, Denmark, Spain, Estonia, Italy Luxembourg, Finland and the United Kingdom.

85 Financial instruments are defined as: 'Shares in companies and other securities equivalents to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing', cf. Collateral Directive, Article 2(1)e).

either involving the transfer of title (such as repurchase transactions or credit support arrangements) or whereby a collateral provider provides financial collateral to a collateral taker, whereby the collateral provider retains ownership of the financial collateral but some security right is established over it (i.e. a pledge, charge, lien, etc.).

The Collateral Directive abolishes all formalities and administrative procedures required to create, validate, perfect or admit in evidence financial collateral arrangements or the provision of financial collateral under such an arrangement (e.g. notarial deeds, registration requirements, notification requirements, public announcements or other formal certification (*data certa*))[87]. If an enforcement event occurs (in or outside insolvency), the realisation of the financial collateral will be possible by sale or appropriation (if agreed) of the financial instruments, and setting-off the amount or applying it in discharge of the relevant financial obligation, without prior notice, court authorisation, public auction or a waiting period[88].

The Directive requires the recognition of the right to re-use pledged collateral, defined as a contractually agreed right of the collateral taker to use financial collateral provided under a security financial collateral arrangement as if it were the full owner (i.e. sell, pledge on, lend, etc.). As soon as the right of use is exercised, the collateral taker incurs an obligation to transfer back equivalent collateral, which, once transferred back, will be treated as if it were the original financial collateral (also in the event of insolvency). The obligation to retransfer may be subject to a close-out netting provision. While the re-use of collateral is highly relevant for financial intermediaries for ensuring an efficient and liquid securities market, it clearly affects the legal position of an investor holding such securities. Thus, for the sake of transparency, Article 5 of the Directive makes such right of use subject to an express agreement between the parties to a collateral arrangement. It remains to be seen what impact the right of re-use will have in practice. The concept is alien to the pre-existing law and practice of many Member States. Moreover, the fact that the language of Article 5 is economic rather than legal in tone may be of little help in easing its incorporation into the Member States' national legal frameworks. Only time will tell to what extent EU market participants will exercise the right of re-use granted by the Collateral Directive. So far, there appear to be no jurisprudence indicating how the courts will interpret and apply the right of re-use, which is especially interesting in view of its interaction with general insolvency law.

The Collateral Directive provides wide-ranging protection against the effects of insolvency proceedings on financial collateral arrangements. This includes the continuing validity of such

86 Cf. Collateral Directive, Article 1(4) b).
87 Collateral Directive, Article 3.
88 Collateral Directive, Article 4.

arrangements even when insolvency proceedings are initiated against one of the parties to the transaction, as required by Articles 4(5) and 8 of the Directive. Moreover, it includes the express recognition of close-out netting arrangements (whether statutory or contractual) in accordance with Article 7 of the Directive. Article 8 of the Directive protects certain typical risk control measures inherent in collateral arrangements, i.e. the substitution of assets or asset-prices related to mark-to-market calculations. Finally, it extends the conflict of laws rule in Article 9(2) of the Settlement Finality Directive (i.e. the rule applying the law of the place where the relevant account is maintained) to all collateral in the form of book-entry securities.

The reduction of risk by increased use of secured transactions, the integration of EU financial markets, and the promotion of financial stability within the Community are all considerably enhanced by these measures. The Collateral Directive has established a largely harmonised framework for collateral in the EU that not only supports modern financial market needs[89], but at the same time facilitates the cross-border use of collateral throughout the EU. Yet, to the extent that the remaining differences in the implementation of the Directive continue to cause distortions or costs resulting from an excessive need for legal due diligence, a higher degree of harmonisation may be warranted. Some modifications may be warranted to help to resolve doctrinal debate and interpretation issues[90]. Moreover, ongoing developments in the financial markets may have to be reflected in the Directive. This may entail, for instance, a review of its material scope of application, with the inclusion of new types of assets that have become important for collateralisation operations for financial market or central bank purposes (e.g. bank loans or receivables). Furthermore, the Directive only recognises a very limited form of netting (bilateral netting in collateral transactions). Market participants have raised concerns in this respect[91], some calling for specific EU legislation on close-out netting, particularly to eliminate inconsistencies between existing close-out netting regimes in the EU. Also, because of lack of consensus or lack of time, the Directive was unable to address some aspects which may require harmonisation in the medium term. These include a revision of the Member States' opt-out clauses, the possible inclusion of issuer or rating-related top-up collateral arrangements, and possible coverage of additional collateral techniques to those covered by the current Directive. Close attention will have to be paid to possible distortions of

[89] This is best illustrated by UNIDROIT's almost literal copying of the core provisions of the Collateral Directive in its draft convention on harmonised substantive rules regarding securities held with an intermediary (cf. below Section V (a).

[90] Cf. Turing/Lester, 'Implementation of the EU Directive on Financial Collateral Arrangements in the United Kingdom', *JIBLR* 2005, p. 65 et seq.; Löber, 'The German Implementation of the EU Directive on Financial Collateral Arrangements', *JIBLR* 2005, p. 72 et seq.

[91] e.g. the ISDA Letter to the Commission regarding the Green Paper on Financial Services Policy (2005-2010), http://www.isda.org/speeches/pdf/EU_GrP_Resp_August-01-2005.pdf;
and the Report of the European Financial Market Lawyers Group (EFMLG) on 'Protection for Bilateral Insolvency Set-off and Netting Agreements under EC Law', October 2004, http://www.efmlg.org/Docs/report_on_netting_final_301004.pdf.

the intended degree of harmonisation resulting from diverging national implementation of certain provisions, a possible example of which is the right of re-use.

The Directive itself calls for its own review by the end of 2006[92]. The Commission has started the review process by gathering the views of the Member States on the state of transposition of the Directive. Given the timing of this exercise, it is possible that this review could be part of a wider review of the harmonisation of the legal framework for securities held through an intermediary, as has been advocated by the Commission in its second Communication on clearing and settlement in the EU in 2004[93]. In this context, account could also be taken of any changes required to the conflict-of-laws provision in Article 9 of the Directive, if the Community and its Member States were to decide to sign and ratify the Hague Convention on certain rights relating securities held with an intermediary[94].

(c) Other relevant legal acts

There are some further EU legal acts which have a bearing on collateral arrangements or clearing and settlement of financial instruments in the EU.

Directive on Markets in Financial Instruments[95]

The Directive on markets in financial instruments (MiFID)[96] is one of the cornerstones of the Commission's Financial Services Action Plan[97]. It requires the Member States to harmonise their rules governing investment services and the pursuit of investment activities. The MiFID is a framework directive, in line with the comitology procedure. The new regime is to take effect on 30 October 2006[98].

The MiFID replaces existing legislation (i.e. the Investment Services Directive[99]) and aims to respond to the structural changes in the EU financial markets. The Investment Services Directive relied mainly on the principle of mutual recognition, but it has been found to be unable in practice to ensure that investment firms can operate throughout the EU on the basis

92 Collateral Directive, Article 10.

93 Commission Communication of 28 April 2004 on Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final).

94 Hague Conference on Private International Law, Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, 13 December 2002, www.hcch.net. The ratification of this Convention would necessitate the prior amendment of the Collateral Directive, whose conflict of laws rule is not compatible with the principle of the Hague Convention.

95 Directive 2004/39/EC of 21 April 2004 on markets in financial instruments, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, (OJ L 145, 30.4.2004, p. 1).

96 OJ L 145, 30.4.2004, p. 1.

97 Commission Communication of 11 May 1999 on implementing the framework for financial markets: action plan, (COM(1999) 232 final).

98 Article 70 of MiFID provides for 30 April 2006. However, on 14 June 2005, the Commission proposed (COM(2005) 253 final) to extend by six months (until 30 October 2006) the deadline by which Member States must transpose the Directive. The proposal also gives firms and markets a further six months (until 30 April 2007) to adapt their structures and procedures to the new requirements.

99 Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, (OJ L 141, 11.6.1993, p. 27).

of approval in their home state[100]. The MiFID now aims to give investment firms an effective 'single passport' to operate across the EU, and to make sure that investors enjoy a high level of protection when employing investment firms, wherever they are located in the EU. It also seeks to establish, for the first time, a comprehensive regulatory framework governing the organised execution of investment transactions by exchanges, other trading systems and investment firms.

The MiFID clarifies and expands the list of financial instruments that may be traded on regulated markets and between investment firms. It also broadens the range of investment services for which authorisation is required under the Directive, notably to include investment advice, and clarifies the ancillary services, such as financial analysis and research, which investment firms may provide, subject to the Directive's provisions on conflicts of interest and conduct of business. The Directive harmonises the regulatory requirements with which investment firms must comply and reinforces the obligations of investment firms when acting on behalf of clients.

The MiFID also allows investment firms to 'internalise' their client orders, defining internalisation as situations where banks and other investment institutions process client orders in-house, without going through a regulated market. However, internalisation is limited to situations which are in the client's best interests. The Directive also sets up a comprehensive regulatory regime covering regulated markets, organised trading facilities (known either as multilateral trading facilities (MTF) or alternative trading systems (ATS)) and off-exchange transactions. It establishes a package of safeguards which regulated markets and investment firms must comply with, for example by establishing a comprehensive transparency regime.

While being aimed primarily at the trading of securities, a number of the MiFID provisions have a bearing on the clearing and settlement infrastructure. The provisions which may have the biggest effect in this respect relate to the safekeeping of client's assets and the access of investment firms to central counterparties and clearing and settlement facilities.

In respect of securities trading, Member States will have to set up a 'single passport' system enabling investment firms to operate throughout the EU. The authorisation of the home Member State may also cover ancillary services, such as 'safekeeping and administration of financial instruments for the account of clients'[101].

With respect to safeguarding clients' assets, Article 13(7) of MiFID states that an 'investment firm shall, when holding financial instruments belonging to clients, make adequate

[100] Cf. Commission press release of 19 November 2002: http://www.europa.eu.int/comm/internal_market/securities/isd/index_en.htm.

arrangements so as to safeguard client's ownership rights'. Under Article 13(8) of MiFID, an 'investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights'.

The Level 2 Advice of CESR[102] contains proposals for the necessary arrangements to be made by investment firms (and by credit institutions when such assets are placed with third parties). According to the CESR Advice, investment firms (if not licensed as a credit institution) 'must deposit' clients' funds with designated institutions, for example credit institutions or central banks[103]. Moreover, investment firms 'may sub-deposit' clients' financial instruments in a depository and, where such depository is 'subject to specific regulation and supervision' under the relevant jurisdiction, the investment firm 'must deposit' the financial instruments of the client in such a depository[104]. When placing instruments in a depository, the investment firm must ensure that clients' financial instruments are separately identifiable from its own and the depository's proprietary financial instruments by virtue of distinctly titled accounts on the books of the depository and through the way the instruments are held by the depository.

As regards regulated markets, the MiFID provides detailed rules on access conditions which are expressly applicable both to their local and their remote participants[105]. Article 33 enshrines the right of foreign firms to have access to regulated markets either through a secondary establishment (a branch) or remotely. However, central counterparties (CCPs) and clearing and settlement systems are outside the scope of the Directive. They are not defined in it and there are no rules in it concerning their authorisation, operational requirements and conduct of business. However, with respect to access to CCPs and clearing and settlement facilities, Article 34(1) of MiFID requires Member States to ensure that investment firms from other Member States have non-discriminatory access to 'central counterparty, clearing and settlement systems in their territory for the purposes of finalising or arranging the finalisation of transactions in financial instruments.' Furthermore, Article 34(2) of MIFID provides that, subject to certain qualifications, Member States must require regulated markets in their territories to offer all their members or participants 'the right to designate the system for the settlement of transactions in financial instruments undertaken on that regulated market'. Article 34(3) of MiFID seems to permit refusal of access on broader grounds than

[101] Cf. MiFID, Article 6(1).

[102] The Committee of European Securities Regulators (CESR), cf. www.cesr-eu.org.

[103] CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, 1st Set of Mandates, January 2005, No 9, p. 36 (see also CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments -1st Set of Mandates where the deadline was extended and 2nd Set of Mandates).

[104] CESR Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments 1st Set of Mandates, January 2005, No 10, p. 36 et seq.

[105] Cf. MiFID, Article 42.

purely risk considerations, since it refers to the 'right of operators of central counterparty, clearing or securities settlement systems to refuse on legitimate commercial grounds to make the requested services available'[106].

This interacts with existing and future supervisory rules on access to clearing and settlement systems. The basic policy considerations for access rights have been formulated in the CPSS-IOSCO recommendations for securities settlement systems[107] and in the corresponding draft ESCB-CESR standards[108]. In short, access criteria should be based only on risk considerations; they should be fair, should comply with standards of equal treatment and should be non-discriminatory (in order to avoid competitive distortions). This would entail equal access to the use of the functions offered by these entities, but would not require that any participant may access any system/entity at any time and at the same price. The fairness requirement would therefore allow differentiation to be based on objective criteria; it would presumably also allow the refusal of 'unreasonable' or 'over-burdensome' access requests.

To these considerations, Article 34(3) seems to add a right for CCPs and securities clearing and settlement systems to apply legitimate commercial criteria to refuse access to foreign investment firms. However, Article 34(3) does not address the nature of the access criteria used by CCPs and securities clearing and settlement systems in general, in other words for both local and remote participants; the nature of access criteria are still subject to national laws, regulations, and decisions by supervisors, as reflected by the rules of each system. Thus, national law or supervisory practice may require CCPs and securities clearing and settlement systems to apply only risk-related criteria for access by all types of participants, or they may allow wider criteria. Thus, Article 34(3) would allow a system to rely on a 'reality/reasonableness/fairness' test to refuse access to a foreign participant for commercial reasons, even where an equivalent local participant might have access to it. However, the MiFID does

[106] See also Recital 48 of MiFID, which states that '[i]n order to facilitate the finalisation of cross-border transactions, it is appropriate to provide for access to clearing and settlement systems throughout the Community by investment firms, irrespective of whether transactions have been concluded through regulated markets in the Member State concerned. Investment firms which wish to participate directly in other Member States' settlement systems should comply with the relevant operational and commercial requirements for membership and the prudential measures to uphold the smooth and orderly functioning of the financial markets'.

[107] 'Recommendations for securities settlement systems' (Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions), November 2001, http://www.bis.org/publ/cpss46.htm; CPSS-IOSCO Recommendation 14, on access, proposes that 'CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access'. It then clarifies that 'criteria that limit access on grounds other than risks to the CSD and the CCP should be avoided'.

[108] 'Standards for securities clearing and settlement in the European Union' prepared by the joint Working Group of CESR and the ESCB. Related information may be found under <www.cesr-eu.org> and <www.ecb.int>. Standard 14, on access, expressly provides that 'CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk'. This was further specified in the section on key elements of the standard which states that 'access criteria that limit access on grounds other than risks to the CSD or CCP should not be permitted'. Cf. also Section VI (b) below.

not prevent national law or supervisory practice defining or circumscribing the 'legitimacy' of such reasons, for example, by approving only a limited number of them and under strict conditions. The use of a strict test for the acceptance of commercial reasons for refusing access to remote participants would also promote the aim of MiFID, which is to enhance remote access to CCPs and securities clearing and settlement systems.

Investment Services Directive[109]

The Investment Services Directive (ISD), which will remain in force until MiFID takes effect on 30 October 2006[110], is far less explicit than the MiFID on the issues referred to above. However, the ISD already gives authorised investment firms (and banks) a 'passport' – a right of direct or indirect access to clearing and settlement facilities provided for members of regulated markets throughout the EU.

Winding-up Directive for credit institutions[111]

The Winding-up Directive for credit institutions, which was to be implemented by 5 May 2004[112], introduced the home-state control principle to insolvencies of credit institutions with branches in other Member States. In doing so, it imposed the principle of a single bankruptcy proceeding and the application of a single bankruptcy law. The Directive contains some provisions relevant to collateral arrangements and netting. It provides for the recognition of set-off in the event of insolvency[113]. It confirms the rule on the application of the law of the place where the relevant register/account is held, for the enforcement of all book-entry financial instruments, whether provided as collateral or held outright (Article 24). Furthermore, it stipulates that netting agreements and repurchase agreements shall be governed solely by the law of the contract governing such agreements (Articles 25 and 26).

Banking Directive[114]

The Banking Directive is the core instrument for achieving a single market in the field of credit institutions, by providing for the granting of a single licence and the application of the principle of home Member State prudential supervision. The Directive provides, *inter alia*, for a common capital requirements regime for credit institutions covering own funds, risk-weighting assets and solvency ratios, as agreed by Basel Committee on Banking Supervision.

[109] Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, (OJ L 141, 11.6.1993, p. 27).
[110] See footnote 98.
[111] Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, (OJ L 125, 5.5.2001, p. 15).
[112] Winding-up Directive for Credit Institutions, Article 34(1).
[113] Winding-up Directive for Credit Institutions, Article 23; cf. also Article 6 of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings [applicable to entities other than credit institutions or insurance companies] (OJ L 160, 30.6.2000, p. 1).
[114] Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, (OJ L 126, 26.5.2000, p. 1).

Article 1(5) of the Banking Directive defines a 'financial institution' as an institution, other than a credit institution, which engages in the activities listed in points 2 to 12 of its Annex I, for example, 'safekeeping and administration of securities'[115]. Article 19 of the Banking Directive requires Member States to provide 'that the activities listed in Annex I may be carried on within their territories, including safe custody services (point 14 of Annex I) thus permitting banks freedom to provide services related to the safekeeping and administration of securities throughout the single market.

The Banking Directive is complemented by the Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in financial conglomerates[116], when the relevant services are integrated in a larger financial group.

Capital Adequacy Directive[117]

The Capital Adequacy Directive (CAD) lays down a standard method for the calculation of capital requirements for the market risk incurred by investment firms and credit institutions, in particular position risks, settlement/delivery risks, and foreign exchange risks[118]. The CAD has subsequently been amended to introduce new market risk provisions, allowing institutions to use 'internal models' for due assessment of market risks (CAD 2)[119].

Some aspects of this Directive and its later revisions are relevant to clearing and settlement: first, on the treatment of exposures to central counterparties, settlement systems and custodians; and second, on the capital requirements of the institutions themselves.

Article 2(9) of Directive 93/6/EEC states that: 'exposures incurred to recognised clearing houses and exchanges shall be assigned the same weighting as that assigned where the relevant counterparty is a credit institution.'

There is no common EU definition of a 'recognised clearing house'. Directive 98/33/EC gives Member States' competent authorities the right (until 31 December 2006) to exempt OTC contracts from counterparty risk requirements, if a central counterparty clearing house is used and if all current and future exposures are fully collateralised on a daily basis. It is not clear whether this latter exemption extends to institutions from a state other than that where the central counterparty is authorised.

[115] No 12 of Annex I of the Banking Directive.

[116] Directive 2002/87/EC of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in financial conglomerates, (OJ L 35, 11.2.2003, p. 1).

[117] Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, (OJ L 141, 11.6.1993, p. 1), as amended by Directive 98/33/EC.

[118] Annexes I, II and III of Council Directive 93/6/EEC.

[119] Directive 98/31/EC of 22 June 1998 amending Council Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, (OJ L 204, 21.7.1998, p. 13). A further revision of the CAD, the proposed Capital Requirements Directive, implementing the Basel II rules on regulatory capital, will have to be applied by the Member States from the start of 2007, with the most sophisticated approaches being applicable from 2008, http://europa.eu.int/comm/internal_market/bank/regcapital/index_en.htm.

No specific capital requirements are imposed on entities providing central counterparty services. However, some European central counterparties are banks, and on that account fall within the scope of the legislation. Central counterparties in Europe use a number of different models to ensure that they have adequate liquid, high-quality resources to cover the risks they incur.

Direct claims on settlement systems tend to arise only where the system itself operates as a bank. Such direct claims will be treated like any other claim on a bank. As far as the capital requirements for the systems themselves are concerned, only those systems that are banks or investment firms are subject to capital requirements. However, as noted above, non-bank systems do not have exposures to their members and are therefore not subject to counterparty credit risk.

Money Laundering Directives

Article 3 of the First Money Laundering Directive[120] requires Member States to ensure that credit institutions and financial institutions require identification of their customers when opening an account or when offering safe custody facilities.

IV. THE EU CLEARING AND SETTLEMENT INITIATIVE

Although the harmonisation efforts referred to above constitute a major step towards the integration of EU financial markets, there has been a strong perception, on the part both of market participants and regulators, that the current situation regarding clearing and settlement in Europe is far from satisfactory.

Although demand for cross-border securities transactions has increased dramatically within the EU since the introduction of the euro, the EU infrastructure for clearing and settlement of cross-border transactions remains highly fragmented. Although there is some evidence that the infrastructure is consolidating, there are still a very large number of entities throughout the 25 Member States which play a role in clearing and settlement. As a consequence, anyone wishing to conduct pan-EU securities transactions faces a plethora of different types of services, different technical requirements/market practices, and different tax and legal regimes[121]. The resulting complexity and costs represent a major obstacle to cross-border securities trading in the Union.

[120] Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering, (OJ L 166, 28.6.1991, p 77).

[121] Cf. the CPSS/IOSCO Recommendations for securities settlement systems, November 2001: 'The legal framework for an SSS must be evaluated in the relevant jurisdictions. These include the jurisdiction in which the system and its direct participants are established, domiciled or have their principal office and any jurisdiction whose laws govern the operation of the system as a result of a contractual choice of law. Relevant jurisdictions may also include a jurisdiction in which a security handled by the SSS is issued, jurisdictions in which an intermediary, its customer or the customer's bank is established, domiciled or has its principal office, or a jurisdiction whose laws govern a contract between these parties.' (http://www.bis.org/publ/cpss46.pdf).

Focusing on the legal aspects, over the last two decades, many EU Member States have modernised the legal infrastructures of their domestic securities industries in order to accommodate two major developments in the world of securities transactions, namely: the growing importance of indirect holding systems; and the trend towards immobilisation and dematerialisation of securities[122].

However, these modernisation measures have been implemented at domestic level, thus maintaining disparities between national legal cultures as to the nature and form of rights relating to financial instruments. In other words, the lack of legal harmonisation persists[123].

At the international level, various bodies have responded to the challenges posed by the cross-border clearing and settlement of financial instruments. In November 2001, the International Organisation of Securities Commissions (IOSCO), and the Committee on Payment and Settlement Systems (CPSS) of the Bank of International Settlements, jointly issued their 'Recommendations for securities settlement systems'[124], giving guidance on the reduction of legal and systemic risk in clearing and securities settlement systems. Not surprisingly, the recommendations refer to the general need for a sound legal framework for such systems and to the imperative of protecting customers' securities against the claims of a custodian's general creditors[125]. Furthermore, in January 2003, the Group of Thirty (G30) published its 'Plan of Action' for global clearing and settlement[126], which basically confirmed the CPSS-IOSCO recommendations and identified some additional questions of substantive law that need to be tackled. These included the need for: effective protection against the risk of losing assets in the event of an intermediary's insolvency; simplifying pledge formalities and the realisation procedures relating to collateral; and harmonised rules of finality of settlement.

[122] For instance: France introduced full dematerialisation of securities in November 1984. There are no longer any certificates, and securities are evidenced by book-entries in accounts maintained by authorised financial intermediaries or by the issuer itself (cf. *Code Monétaire et Financier*, Art. L 431-2). In Belgium, in 1967, an investor's interest was defined as a co-proprietary right, consisting of a notional portion of a pool of assets of the same type held by an intermediary for all its clients collectively. The investor's title is the book-entry and not a physical or dematerialised security (cf. Royal Decree No. 62, 10 November 1967, as amended by Royal Decree of 27 January 2004). In Luxembourg, an investor has a right of (co-)ownership in a given pool of non-individually identified securities of the same type held by an intermediary on behalf of all the owners of the same type of securities (cf. Arts. 6, 7 and 15 of the Law of 1 August 2001).

[123] Cf. 'Harmonisation of the legal framework for rights evidenced by book-entries in respect of certain financial instruments in the European Union', Report of the European Financial Markets Lawyers Group, June 2003, p. 7.

[124] CPSS/IOSCO, 'Recommendations for securities settlement systems', November 2001, http://www.bis.org/publ/cpss46.pdf.

[125] Cf. in particular Recommendation 1 ('Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions'); Recommendation 12 ('[…] It is essential that customers' securities be protected against the claims of a custodian's creditors'); Recommendation 19 ('CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements').

[126] The Group of Thirty, 'Global Clearing and Settlement – A Plan of Action', January 2003, http://www.group30.org/call.htm.
See also the Interim Report of progress, April 2005, http://www.group30.org/docs/Interim05.pdf.

In line with these developments, in April 2001, the Commission launched an initiative to validate perceived obstacles to cross-border securities market transactions in the EU and to identify the public policy issues and the knock-on effects from potential models for the future structure(s) for clearing and settlement[127]. In doing so, the Commission relied heavily on the knowledge and experience of an advisory group on financial market issues chaired by Alberto Giovannini (the 'Giovannini Group').

(a) The work of the Giovannini Group

The Giovannini Group is a group of financial sector experts, whose purpose is to advise the Commission on financial market issues. Formed in 1996, the Group aims to identify inefficiencies in EU financial markets and to propose practical solutions for improving market integration. The Commission's Directorate-General for Economic and Financial Affairs provides the secretariat for the Group, and officials from the Directorate-General for the Internal Market and Services and from the ECB also support the Group's work.

Of the Group's first three reports, the first, in 1997, considered the likely impact of the introduction of the euro on capital markets[128] and helped to forge a common approach to the re-denomination of public debt in euro and to establish common bond-market conventions for the euro area; the second, in 1999, focused on the EU repo market, addressing problems related to national differences of infrastructure, market practices and the legal/fiscal frameworks[129]; and the third, in 2000, examined the scope for improving the efficiency of euro-denominated government bond markets by means of more coordinated issuance between the euro area Member States[130].

The Giovannini Group was subsequently mandated by the Commission to identify the requirements for efficient clearing and settlement arrangements in the EU and to propose improvements to such arrangements. In carrying out its work, the Group took note of the activities already undertaken by other groups such as the G30, CPSS-IOSCO and ESCB-CESR and of their respective contributions to the ongoing debate on clearing and settlement at both EU and global levels. In doing so, the Giovannini Group took care to avoid duplication of work and to ensure the consistency of any recommendations made.

In November 2001, the Group issued its first report on cross-border clearing and settlement arrangements in the EU[131]. The ambit of this report was mainly diagnostic, in that it provided a stylised description of clearing and settlement processes, an indication of the additional risk

[127] http://Europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm.
[128] Commission Communication of 2 July 1997 - The impact of the introduction of the euro on capital markets (COM(97) 337 final),\.
[129] 'EU repo markets: opportunities for change', October 1999.
[130] 'Co-ordinated public debt issuance in the euro area', November 2000.
[131] 'Cross-border clearing and settlement arrangements in the EU', November 2001.

associated with operating these processes on a cross-border (i.e. cross-system) basis, an overview of current institutional arrangements in the EU, a tentative indication of the relative cost differential between settling domestic and cross-border securities transactions, and a list of 15 barriers identified by market practitioners as preventing the efficient provision of cross-border clearing and settlement services within the EU.

The main conclusion of the report was that the fragmentation existing in the EU did indeed complicate the post-trade processing of cross-border securities transactions and create barriers to clearing and settlement services[132].

The Group did not propose an ideal clearing and settlement model, but rather a structure that would work efficiently on a pan-EU basis. It concluded that it is an essential requirement of a financial system that its clearing and settlement should be efficient. However, the achievement of this objective would require input not just from experts, but also from non-experts such as senior managers and public policymakers. In that context, the work of the Group has been an attempt to bridge the gap between the highly technical nature of the problems involved in integrating EU clearing and settlement systems and the policy decisions that must be taken to resolve those problems.

As for the 15 barriers to efficient cross-border clearing and settlement identified and listed by the Group, they can be divided into three categories: (i) national differences in technical requirements and market practices, (ii) national differences in tax procedures, and (iii) issues relating to legal certainty.

The differences identified in national technical requirements and market practices are the following: operating hours/settlement deadlines; IT platforms/interfaces; availability/timing of intra-day settlement finality; settlement periods; rules governing corporate actions; securities issuance practice; remote access; restrictions on the location of clearing and settlement; restrictions on the location of securities; and restrictions on the activities of primary dealers and market-makers.

As for tax barriers, the report lists withholding-tax procedures as disadvantaging foreign intermediaries and tax collection functionality.

Finally, the legal barriers are listed as: (i) the absence of an EU-wide framework for the treatment of interests in securities (Barrier 13), highlighting different concepts of property and ownership in the EU Member States, and the need for true finality for transfers of securities; (ii) national differences in the legal treatment of bilateral netting for financial transactions (Barrier 14), with added emphasis on multilateral netting schemes to be established in the

[132] Ibid. ii.

context of clearing systems; and (iii) the uneven application of national conflict-of-laws rules (Barrier 15).

More specifically, in respect of legal barriers, the report states:

> 'The third type of barriers reflects the existence of different legal rules defining the effect of the operation of a system, including different legal structures concerning securities themselves. This type of barrier is of a different order to the others. Barriers of market regulation and of tax can generally be changed or abolished without affecting basic legal concepts. However, laws about what securities are and how they may be owned form a basic and intimate part of the legal systems of Member States, and to change them will have many ramifications. Barriers related to legal certainty trouble securities settlement systems, clearing systems, and market intermediaries equally.'[133]

Furthermore, the report states that whenever

> 'there is a difference of treatment between two jurisdictions concerning a particular security, there will be uncertainty about which claims to own that security will prevail. This legal uncertainty can be exacerbated by the fact that foreign investors are sometimes obliged to use local infrastructure for clearing and settlement. Uncertainty is increased still further by the fact that securities themselves are legally complicated, not homogeneous, and vary widely in their legal characteristics.' [134]

Consequently, in considering the scope for removing these barriers, a distinction was made between those barriers that can be addressed by the private sector alone and those that can be addressed solely on the basis of Government intervention. The Group recommended that EU clearing and settlement could be significantly improved by the market-led convergence of technical requirements and market practices across national systems. This would provide for interoperability between national systems and could deliver significant benefits considerably sooner than the time required for full mergers of systems. However, the removal of barriers related to taxation and legal certainty was clearly considered to be the responsibility of the

[133] Ibid., p. 54.

[134] Ibid., p. 54; three particular dichotomies are mentioned: (i) Equities are very different from debt securities. Equities are the creations of national legislation. Every EU company can only issue shares under and in accordance with the law of its country of incorporation. No matter where and how these shares are traded, or rights in them are traded, one can never completely escape from the national regime that created them. Debt securities, by contrast, can be issued with a free choice of form, and the terms and conditions of the debt. (ii) In certain circumstances, some EU legal systems recognise a difference between outright ownership of a security and an entitlement against a settlement system (or intermediary) to own such a security. Others treat the two as the same. (iii) Some debt securities are physical, but most are not. Bonds may be constituted by physical paper (either held by investors, or immobilised). They may consist of interests recorded in an accounting system that are deemed to replace physical papers. They may be issued in a fully dematerialised form, and recorded in the books of a system, or of an intermediary, or recorded in a register.

public sector. As for tax-related barriers, the Giovannini Group advocated harmonising the procedures for securities taxation as a further means for facilitating the integration of EU financial markets. As for the legal issues, the Group considered that the legal barriers reflect more fundamental differences in the concepts of underlying national laws, and it would appear to be more difficult to remove legal barriers than barriers in the other categories.

Building on the analysis presented in the 2001 report and subsequent input, such as the first Commission Communication on clearing and settlement[135], the Giovannini Group issued a second report on EU clearing and settlement arrangements[136] in 2003. This second report attempts to provide solutions to the problems identified in the November 2001 report.

The report suggests that the inefficiencies in EU cross-border clearing and settlement arrangements should be eliminated by removing the 15 barriers identified in the first Giovannini report of 2001, stating that efficiency in EU clearing and settlement arrangements cannot be optimised within an environment of multiple regulatory, fiscal and legal regimes[137].

The report proposes a strategy for removing the barriers by identifying the actions required, allocating responsibility for those actions (involving both the public and the private sectors) and establishing a tight timetable for achieving them. More specifically, the report proposes a sequence of immediate actions and a timetable (within two to three years depending on the specific barrier) for the elimination of the 15 barriers that is consistent and minimises market disruption and risks. In its suggestions, the Group recognised that some barriers are more important than others and some are interdependent, so that there is merit in establishing a sequence for their removal that minimises the efforts and risks involved.

The report clearly identifies the specific action needed to remove each barrier and who should be responsible for that action. Depending upon the nature of each barrier, the responsible entities could either be public authorities, such as supervisors, central banks or legislators, or private sector groupings, such as the European Central Securities Depositories Association (ECSDA)[138], the Society for Worldwide Interbank Financial Telecommunication (S.W.I.F.T.)[139], or the International Primary Dealers Association (IPMA, now merged to form the International Capital Market Association – ICMA)[140]. Where coordinated action between more than one entity is required, coordinators had been identified[141].

135 Commission Communication of 28 May 2002 – Clearing and settlement in the European Union – Main policy issues and future challenges, (COM(2002) 257 final).
136 Second Report on EU cross-border clearing and settlement arrangements, April 2003.
137 Ibid.. p. i.
138 www.ecsda.com.
139 www.swift.com.
140 www.icma-group.org.
141 Second Report on EU cross-border clearing and settlement arrangements, p. 4 et seq.

In a separate section, the report analyses the public policy aspects of consolidation in the context of the objective of cost-effective, competitive and systemically sound EU clearing and settlement arrangements, and examines the alternative structures for achieving this objective[142].

As regards the three legal barriers identified in the first report (i.e. (i) the absence of an EU-wide framework for the treatment of rights in respect of securities (rights referred to as 'ownership' to imply a distinction from mere contractual rights for the delivery of securities); (ii) national differences in the legal treatment of netting; and (iii) national differences about how to resolve conflicts of laws), the second report confirms that these legal barriers are seen to be critical for the trading of securities in the EU.

The first of these is seen as being the main barrier. The second and third are regarded as being well on the way to resolution, mainly by virtue of the Collateral Directive, which removes much of the legal uncertainty on netting and the uneven application of conflict of laws rules[143].

However, as regards the lack of an EU-wide framework for the treatment of rights in respect of securities, the report sees a need for a thorough modernisation of substantive laws. It considers that the creation of a clear conflict-of-laws rule is not enough to resolve issues of legal uncertainty. The problems of inter-connection will persist as long as national legal systems are based on fundamentally different concepts.

The Giovannini Group proposes that the modernisation of substantive securities law is the way to resolve these issues[144]. In doing so, the focus of the reform should be on book-entries in (securities) accounts. This reflects the fact that in modern securities markets, the vast majority of securities are held for others by intermediaries, for which purpose these intermediaries maintain securities accounts. In the view of the Giovannini Group, these accounts are treated commercially and economically as the focus of ownership. However, despite the commercial similarities, their legal status differs across the EU. There is a lack of clarity about who has what rights when securities are held for investors by means of an intermediary's book-entries.

[142] Ibid., p. 22 et seq.
[143] See also the comments on the Collateral Directive in Section III (b) above.
[144] Second Report on EU cross-border clearing and settlement arrangements, p. 14 et seq.

Consequently, the proposed way forward, to create a harmonised legal framework across the EU for securities held with an intermediary[145], is that accounts should establish and provide evidence of proprietary rights in securities[146]. More specifically,

> 'a transfer of legal title or pledge should be evidenced by book-entry in the respective accounts or through other appropriate measures such as earmarking procedures on the intermediaries' accounts.' [147]

Furthermore, the report recommends that the legal nature of 'ownership rights' in securities should be harmonised. It suggests that the reform should be built around five central concepts, namely investors' 'ownership rights', protection from insolvency of the intermediary, tradability, protection for acquirers and investor protection. It goes on to specify those concepts as follows[148]:

- *investors' ownership rights:* the extent and exact nature of the rights of investors whose securities are held on an account with an intermediary must be clear and transparent;
- *protection from insolvency of the intermediary:* that investors' assets are not available to the creditors of the intermediary nor to the intermediary itself;
- *tradability:* that dealings take place by debits and credits to the relevant account, and the *bona fide* acquirer can rely on such credits;
- *protection for acquirers:* that priorities between competing interests are determined by the order in which they are recorded to the relevant account; and
- *investor protection:* that those maintaining securities accounts must have adequate protection mechanisms in place (including such as arise from being supervised) to avoid shortfalls and to deal with shortfalls should they occur.

However, the report remains silent on what should be the preferred extent and exact nature of the investor's 'ownership rights' or the legal consequences of book-entries 'evidencing' such rights. Instead of elaborating on legal details, the report suggests establishing a 'Securities Account Certainty Project' at the level of the European Union,

145 Ibid., p. 14.
146 Like 'intermediary', the term 'proprietary' is susceptible to misinterpretation. Its meaning may range from ownership rights or traditional rights *in rem* to merely being the opposite of a purely contractual right. The Giovannini reports seem to prefer the term 'ownership rights' used in a wide sense. In the following, unless otherwise stated, the term 'proprietary' is used synonymously with a right *in rem*.
147 Second Report on EU cross-border clearing and settlement arrangements, p. 15.
148 Ibid., p. 15.

> '[to] be agreed upon by national governments, with a mandate to draft detailed proposals for the target reform and to explore and progress options for the work once concluded to be implemented into the laws of EU Member States' [149].

It is proposed that such a project should be carried out by a group of legal experts coming from a wide range of backgrounds, including academics and the public and private sectors. The report goes on to specify that the aim should not be the complete harmonisation of substantive laws relating to securities (i.e. not a 'European securities code'), but rather a limited harmonisation focused on the elements identified by the second report of the Giovannini Group. The report also clarifies that no tax, accounting or competition aspects should be addressed by the project, which should concentrate on purely legal issues. The Giovannini Group estimates that such a project would take about three years, considerably longer than for any of the other barriers identified, and not including the subsequent implementation of any proposals resulting from such Securities Account Certainty Project.

(b) The report of the European Financial Markets Lawyers Group

In parallel with the work of the Giovannini Group, other entities have analysed the legal aspects of clearing and settlement. Already in 2000 the European Financial Market Lawyers Group (EFMLG) began its own analysis of the existing diversity of the Member States' legal and operational frameworks for the indirect holding of financial instruments.

The EFMLG was established in 1999 on the initiative of the ECB. The group is composed of about 25 lawyers working for those EU-based credit institutions that are most active in the European financial markets. The members of the group[150] are selected on the basis of their personal professional expertise and do not represent their institutions in the EFMLG[151].

The establishment of the EFMLG was prompted by the perception that the European financial markets were hampered by the lack of a single set of legal rules. Cross-border market participants in the EU still have to cope with the existence of as many different legal systems as there are Member States. Consequently, the EFMLG's central task is to identify and promote legal initiatives that would support the harmonisation of EU financial market activities. The EFMLG operates by analysing topics that have been identified as being obstacles to a fully-fledged single European financial market[152], paying close attention to the

[149] Ibid., p. 16.
[150] A list of the current members can be found on the EFMLG's website www.efmlg.org.
[151] The group is chaired by Antonio Sáinz de Vicuna, Director-General of Legal Services at the ECB.
[152] Past or current topics include: legal barriers to the cross-border use of collateral; the use and effectiveness of master netting agreements; the concept of *force majeure* in market documentation; termination and close-out of trades under master agreements; the conflict of laws rule applicable to cross-border securities transactions; a pan-European definition of 'business day' and/or 'bank holiday'; legal aspects of 'repurchase transactions'; and the role of rating agencies.

activities of other relevant groupings[153]. Depending on the subject matter, the group makes recommendations for legislative action or for best market practice. One of the most recent examples is a report on the treatment of insolvency set-off and netting in Community law[154].

The EFMLG has paid particular attention to the issue, holding and use of financial instruments in capital market transactions. Related activities have resulted in a report proposing an EU directive on collateralisation, which was published in June 2000[155]. The European Commission referred to this report as one of the main documents supporting the preparatory work for the Collateral Directive. Another example is the group's work on legal aspects of short-term securities, a project which was undertaken jointly with the ACI (Financial Markets Association)[156].

In 2000, the EFMLG concluded that the barriers to harmonisation of the EU internal market, in particular for securities, arose as much from the differences between legal systems as from the differences between the regulatory regimes. The earlier work of the EFMLG on the legal concepts of debt had shown that a number of these differences arose from the different rules on the form in which and the terms under which debt may be issued and traded.

In response, the EFMLG started its own analysis of the legal and operational framework for the indirect holding of financial instruments in the EU, which led to a report published in June 2003[157]. The identified barriers to cross-border trading of securities fully confirm the findings of the second Giovannini report. Consequently, the EFMLG strongly supports the Giovannini Group's proposal for an EU Securities Account Certainty Project. Furthermore, it concluded that Community legislation in the form of a directive is needed to allow financial instruments to be transferred by way of book-entries identically throughout the EU, and under sufficiently harmonised terms so that the differences will no longer constitute barriers to cross-border trading in securities[158].

The EFMLG report goes beyond identifying the barriers and suggests specific measures that could constitute an EU-wide approach for overcoming the existing legal hurdles. It is proposed that the effects of book-entries in securities accounts should be based on certain

[153] For example the Financial Markets Lawyers Group at the Federal Reserve Bank in New York, the Financial Law Board at the Bank of Japan or the Financial Markets Law Committee at the Bank of England (see links page at www.efmlg.org). In addition, depending on the topic concerned, the EFMLG liaises with relevant market or industry organisations.

[154] 'Protection for bilateral insolvency set-off and netting agreements under EC law', October 2004.

[155] 'Proposal for an EU directive on collateralisation', June 2000.

[156] EFMLG consultation report 'The money market - Legal aspects of short-term securities', September 2002. All cited documents can be found under www.efmlg.org.

[157] Report on 'Harmonisation of the legal framework for rights evidenced by book-entries in respect of certain financial instruments in the European Union', June 2003.

[158] Ibid, p. 4.

harmonised characteristics in all Member States. In particular, a high degree of harmonisation is seen to be required in respect of the following[159]:

- the exact nature and extent of an investor's right, as evidenced by a book-entry,
- the protection of investors' rights to the maximum extent possible, especially in the case of an intermediary's insolvency,
- the full tradability of rights in securities as evidenced by book-entries, including the protection of acquirers in good faith,
- the safeguarding of the safety of a system of holdings of securities by book-entries by double-entry bookkeeping, and
- clear rules for movements of securities on accounts.

Based on these principles, the EFMLG report recommends specific legislative action to harmonise the legal regime for holding and transferring financial instruments by way of book-entries, to take full advantage of the huge advances in computer technology and the desire for a barrier-free internal market for financial instruments. The recommendations for legal harmonisation are based on two pillars; on the one hand, specific rules for the organisation of the securities infrastructure, and on the other hand, harmonisation of the effects of book-entries.

As regards the rules for the organisation of the securities infrastructure, the EFMLG report deals with the role and functions of the participants and the requirements for the system's security. No specific clearing and settlement infrastructure is promoted in this connection. While recognising the need for a clear definition of the roles and functions of the various entities participating in the securities market, the EFMLG report pursues a functional approach by focusing on the activities of account administration and custody[160]. As regards the security of the system, double-entry bookkeeping and clear rules on the segregation of accounts are suggested as the main safeguard measures. Also, movements of financial instruments should be based on clear rules, whereby account entries should only be made under instruction from an authorised entity[161].

As for harmonising the effects of book-entries, the EFMLG report advocates a wide material scope of application, including not only bonds and equities, but also other widely used assets, such as money market instruments. The report suggests that a system of full statutory dematerialisation would be best suited to take full advantage of the effects of this

159 Ibid, p. 5.
160 Ibid, p. 17 et seq.
161 Ibid, p. 19 et seq.

harmonisation measure[162]. However, the main focus is on securities holdings by intermediaries rather than on the form in which financial instruments are issued. The protection of investors' rights in securities is seen as the central element of the new regime. Rights should be proprietary rather than merely contractual, ensuring full ring-fencing against an intermediary's insolvency. The use of rights by an intermediary should only be possible with the investor's consent, and there should be adequate protection mechanisms against shortfalls, including insurance and a pro-rata sharing of losses. It is proposed that transfers of rights in financial instruments should be carried out by corresponding book-entries, with clear rules about the moment of transfer of rights. Attachment of rights and measures blocking them should not be possible at the upper-tier level, and third parties acquiring financial instruments in good faith should be protected against challenges or the encumbrance of the acquired rights by third parties[163].

The EFMLG report shows how a Community legal act, structured along the lines suggested above, might remove the legal barriers to further integration of the EU internal market for financial instruments. The EFMLG proposal does not suggest full harmonisation of substantive securities law or property law, nor does it advocate a uniform securities code. It is complementary to the Giovannini Group's proposal for an EU Securities Account Certainty Project, by providing background for the drafting of detailed proposals and showing that such a reform is not only desirable, but also technically feasible.

(c) The activities of the European Commission

In parallel with the work carried out under the various initiatives in the area of clearing and settlement, the Commission has developed its own policy for creating an integrated clearing and settlement environment and supporting the efficient post-trade processing of securities transactions within the EU.

Drawing on the 2001 Giovannini report and other relevant work[164], on 28 May 2002 the Commission issued a Communication on clearing and settlement[165]. The Communication was a consultative document and represented the first step towards defining the Commission's strategy for clearing and settlement arrangements in the EU.

In keeping with the aims of eliminating excessive cross-border costs and minimising legal or other risks arising from inefficient clearing and settlement[166], the Commission acknowledged

162 Ibid, p. 20 et seq.
163 Ibid, p. 22 et seq.
164 Such as the work of the G-30, CPSS/IOSCO and the joint working group of CESR and ESCB.
165 Commission Communication of 28 May 2002 on Clearing and settlement in the European Union: Main policy issues and future challenges, (COM(2002) 257 final); http://www.Europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm#com.
166 Ibid., p. 4.

the findings of the Giovannini Group regarding the barriers to achieving these aims. It confirmed the Group's view that much of the inefficiency in EU cross-border clearing and settlement derives from fragmentation due to national differences in technical requirements/market practice, tax procedures and laws applying to securities. However, the Commission added that, in addition to the lack of a common regulatory approach to clearing and settlement activity, concerns over operational and prudential risks may also act as an impediment to the development of cross-border activity.

The Commission identified two main objectives. The first objective is the removal of the 15 Giovannini barriers[167]. The removal of technical barriers should be pursued by the private sector with the support of public authorities, whereas the other barriers are seen to require public intervention. As, in the Commission's view, the removal of the barriers alone would not necessarily result in a fair and competitive environment, the second objective should be to remove competitive distortions or unequal treatment of entities performing similar clearing and settlement activities. This would entail transparent, objective and effective rights of access to systems, and the removal of restrictions on the locations of counterparties, securities or infrastructures. The parallel application of competition policy is seen as reinforcing these measures.

The Commission submitted its ideas to all interested parties in a public consultation in 2002. On the basis of the replies received and the further work of the Giovannini Group[168], the Commission further refined its policy and, on 28 April 2004, issued a second Communication on cross-border clearing and settlement in the EU[169] (the 'Second Communication').

This Second Communication is based on the premise that cross-border clearing and settlement is generally considered to be potentially less safe, less efficient, and more expensive than the purely domestic kind, and that inefficiencies are due to a lack of global technical standards, the existence of divergent business practices, and inconsistent fiscal, legal and regulatory underpinnings[170].

The Commission bases its approach on a number of considerations, including the main objective of achieving an efficient, integrated and safe market for securities clearing and settlement. In the Commission's view, further consolidation in clearing and settlement in the EU should be mainly market-driven, as long as legitimate public policy concerns are met. The

167 Operating hours/settlement deadlines; IT platforms/interfaces; availability/timing of intra-day settlement finality; settlement periods; rules governing corporate actions; securities issuance practice; remote access; restrictions on the location of clearing and settlement; restrictions on the location of securities; and restrictions on the activities of primary dealers and market-makers.

168 In particular, the Second Report on EU cross-border clearing and settlement arrangements, April 2003.

169 Commission Communication of 28 April 2004 - Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final); http://Europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0312en01.pdf.

170 Ibid., p. 6.

Commission considers that the integration of securities clearing and settlement systems will require the combined intervention of market forces and public authorities, with the Commission acting as coordinator.

In order to achieve this objective, the Commission considers that four main strands of measures need to be pursued[171]: (a) the liberalisation and integration of the existing securities clearing and settlement infrastructure through the introduction of comprehensive access rights at all levels and the removal of existing barriers to cross-border clearing and settlement; (b) the continued application of competition policy to address restrictive market practices and to monitor further industry consolidation; (c) the creation of a common regulatory and supervisory framework that ensures financial stability and investor protection, leading to the mutual recognition of systems; and (d) the implementation of appropriate governance arrangements.

The Second Communication was subject to a public consultation, which brought more than 80 responses from public authorities, infrastructure providers, banks, issuers, industry associations and law firms[172]. While the responses were largely supportive of the Commission's proposals, the degree of support varied depending on the specific measures, with the proposed governance structure receiving the highest number of critical reactions.

The Second Communication proposes a number of practical initiatives which, in the Commission's view, are needed in order to create the necessary impetus: (1) the setting up of an 'Advisory and Monitoring group' to tackle all the Giovannini Barriers for which the private sector has sole or joint responsibility and to promote the overall integration and liberalisation project; (2) a possible proposal for a framework directive on clearing and settlement for a secure legal framework for ensuring freedom to provide securities clearing and settlement services throughout the EU on the basis of common requirements; (3) addressing legal and tax issues by setting up expert groups to consider the legal and tax-related barriers to integration; and (4) ensuring the effective implementation of competition law[173].

The Second Communication also led to an intense debate in the European Parliament. The Parliamentary Committee on Economic and Monetary Affairs prepared a Report on Clearing and settlement in the European Union, reflecting the proposals made by the Commission. After a first, quite sceptical draft of 6 June 2005 (Rapporteur Theresa Villiers), the

[171] *Ibid.*, p. 8.
[172] Most of the respondents permitted the publication of their answers on the Commission's website http://www.Europa.eu.int/comm/internal_market/financial-markets/clearing/contributions_en.htm.
[173] Commission Communication of 28 April 2004 - Clearing and Settlement in the European Union – The way forward*,* (COM(2004) 312 final), p. 11 et seq.

Committee produced a final report (Rapporteur Piia-Noora Kauppi)[174] which was submitted to Parliament with a request for a resolution, and was adopted by the Parliament on 7 July 2005[175]. While supporting the general aims of the Commission to achieve an efficient, integrated and safe market for clearing and settlement in the EU and bring down costs, the Parliament is more cautious about the need for harmonised regulation. In this respect, it welcomes the Commission's decision to conduct an impact assessment which, in the Parliament's view, should include a thorough cost-benefit analysis of both legislative and non-legislative options, and their respective scope[176]. However, in respect of the legal barriers, the European Parliament emphasises its views that

> 'inconsistencies between national laws on transferring financial instruments are one of the main reasons why costs are higher for cross-border than for domestic transactions'.

Consequently, it supports ongoing attempts to harmonise these laws, while acknowledging that 'this project could take many years to complete' and welcomes the setting-up by the Commission of the Legal Certainty Group. It urges the Commission to step up the work of that group as a priority instrument for promoting convergence at European level[177]. Finally, the Parliament believes that there is a need to effectively enforce and improve existing legislation.

Possible framework directive on clearing and settlement

In its Second Communication, in line with its earlier publications, the Commission considers that the removal of technical and market practice barriers cannot be left entirely to the private sector to resolve. In particular, as regards the establishment of comprehensive rights of access and choice, a common regulatory framework, and appropriate governance arrangements, it sees the potential need for a framework directive. The alternative, namely reliance on voluntary action by national legislators or regulators, is considered much less certain and no guarantee of EU-wide liberalisation for a long time.

A framework directive would allow the development of high-level principles as a first step, with further implementing measures (Level 2 measures, in line with the Lamfalussy process described above) being prepared subsequently, in accordance with an enabling clause in the framework directive.

[174] Report on Clearing and settlement in the European Union (2004/2185(INI)), http://www.europarl.eu.int/registre/seance_pleniere/textes_deposes/rapports/2005/0180/P6_A(2005)0180_EN.pdf.

[175] http://www.europarl.eu.int/registre/seance_pleniere/textes_adoptes/definitif/2005/07-07/0301/P6_TA(2005)0301_EN.doc.

[176] Ibid, No 7.

[177] Ibid, No 15.

As may be deduced from the Second Communication[178], to ensure a level playing field such a possible future directive might adopt a functional approach as to its coverage. This is a reflection of the fact that in the provision of clearing and settlement services, institutions are increasingly breaking away from traditional, clearly defined roles, and blurring the distinctions between the activities performed by different entities. This might warrant a regulatory regime based on the principle that each activity should be governed by reference to the risks inherent in that activity, rather than by reference to a type of institution. Thus, entities which provide the same functions/services would be subject to the same rights and obligations. This, in turn, would necessitate a definition of activities and an analysis of risk.

As for the material scope of such a possible future directive, the Second Communication considers giving far-reaching rights to infrastructure providers and users with regard to their access to and choice of preferred clearing and settlement systems[179]. Access should be governed by transparent and non-discriminatory rules, based on objective criteria. Furthermore, in order to avoid discrimination, any variation from standard service levels or pricing should also be justified on objective grounds.

The Communication is also considering the establishment of initial and ongoing prudential and investor protection requirements, with supervision being based on the principles of home-state control and supervisory cooperation.

Lastly, in respect of governance arrangements, in order to avoid cross-subsidies, to provide for the unbundling of non-core activities, and to ensure banking services which at least offer the choice of settling in central bank money, the communication proposes a number of measures such as accounting separation of core activities (custody, settlement, pre-settlement) and non-core activities.

Following the announcements of the Commission, throughout 2005 the Directorate-General Internal Market and Services has been working on an Impact Assessment which is scheduled to be finished in the first quarter of 2006. According to the Commission, if the case for a directive were to be proven and the Commission were to decide in favour of legislative action, such a proposal could be prepared in mid-2006 and could be officially proposed in the third quarter of 2006[180].

[178] Commission Communication of 28 April 2004 - Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final), p. 13 et seq.

[179] More specifically, this would entail: for investment firms and banks, the right to access securities clearing and settlement systems located in other Member States; for central counterparties, the right of access to central counterparties and securities settlement systems located in other Member States; for securities settlement systems, the right of access to securities settlement systems located in other Member States; for regulated markets and multilateral trading facilities, the right to enter into appropriate arrangements with central counterparties and securities settlement systems located in other Member States.

[180] Cf. CESAME, Synthesis Report of the meeting held on 24 October 2005, p. 1, http://europa.eu.int/comm/internal_market/financial-markets/docs/cesame/synthesis-report-241005_en.pdf.

Clearing and Settlement Advisory and Monitoring Expert Group (CESAME)

As another key measure, the Clearing and Settlement Advisory and Monitoring Expert Group (CESAME) was established in July 2004[181]. According to its mandate[182], CESAME is required to coordinate private and public sector activities for the removal of the barriers. This entails monitoring the progress and sequencing of private sector initiatives, as well as ensuring the consistency of the overall implementation process. CESAME is also required to promote the overall project and ensure transparency at all times. Furthermore, upon request CESAME provides the Commission with informal advice and assistance on specific technical issues. Finally, it liaises with the parallel groups of experts dealing with legal and tax related barriers, and at the international level with the Group of 30 and other international bodies, to ensure the consistency of initiatives in the EU with those in the wider world.

The Group is chaired by the Commission[183], with Alberto Giovannini acting as Principal Policy Adviser. It is made up of 21 private sector participants from a wide range of backgrounds, including global custodians, central securities depositories, international central securities depositories, exchanges, central counterparties and issuers. In addition, there are four public sector observers from supervisory authorities and central banks, including the ECB. The Group had two meetings in 2004 and three meetings in 2005, with further meetings planned for 2006[184].

Legal and tax expert groups

In addition to CESAME, in early 2005, the Commission established two further expert groups, one dealing with legal barriers (the Legal Certainty Group, see below under the Legal Certainty Project) and another dealing with barriers related to tax procedures (the Fiscal Compliance Group (FISCO)[185]). Both groups are mandated to consider the legal and tax-procedure related barriers to integration respectively, to evaluate the existing situation and, if need be, to suggest methods for harmonising national laws and/or procedures.

(d) The Legal Certainty Project

Among the Giovannini barriers, particular attention was given to legal barriers. The Second Communication reflects this by stating:

[181] Financial services: Commission sets up expert group on clearing and settlement, Commission press release, 16 July 2004.

[182] http://europa.eu.int/comm/internal_market/financial-markets/docs/cesame/mandate_en.pdf.

[183] The Chairman is David Wright from the Commission's Directorate-General Internal Market and Services.

[184] See the CESAME website for documents and information on the group's activities: http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en.htm.

[185] For the composition and activities of FISCO, see the group's website: http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm.

‘The legal framework [for clearing and settlement in the EU] should be clear, reliable, coherent and predictable in its interpretation and implementation.’[186]

The most prominent of the legal barriers is the lack of an EU-wide framework for the treatment of interests in securities held by an intermediary. This is seen as the single most important source of legal risk in cross-border transactions.

This focus reflects the fact that laws, in particular property, securities and insolvency laws, as well as the rules governing systems, all influence the way in which securities clearing and settlement can be performed. In a cross-border environment, this involves multiple jurisdictions, representing differing legal traditions and approaches. Even if the applicable substantive law is identified with reasonable certainty, differences and a lack of interoperability between the substantive laws of the various jurisdictions concerned may still adversely affect the process.

The Commission has responded to this challenge by advocating a comprehensive approach called, somewhat ambitiously, the Legal Certainty Project[187]. In the Second Communication, it expressly endorsed the suggestions made by the Giovannini Group, but it goes beyond the proposal in the Second Report of the Giovannini Group for a Securities Account Certainty Project. Like the Giovannini Group, the Commission calls for an initiative that will lead to the creation of a harmonised EU-wide framework for the treatment of interests in securities held by an intermediary but, over and above this, it is the Commission’s view that the project should also cover differences in national laws on corporate action processing and restrictions relating to an issuer’s ability to choose the location of its securities.

Specifically, the Commission proposes to address the following eight issues:

- the nature of an investor’s rights in relation to securities held in an account with an intermediary;
- the transfer of these rights;
- the finality of book-entry transfers;
- the treatment of upper-tier attachments;
- investor protection from insolvency of the intermediary;
- the acquisition of these rights in good faith by third parties;
- differences in national legal provisions concerning corporate action processing; and

[186] Commission Communication of 28 April 2004 - Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final), p. 22.

[187] Ibid., p. 22.

- restrictions relating to the issuer's ability to choose the location of its securities[188].

The first six of these issues form subsets of the overall aim to create a harmonised EU-wide framework for the treatment of interests in securities held by an intermediary, and basically endorse and refer back to the five guiding principles set out in the Second Report of the Giovannini Group[189]. Like the Giovannini reports, the main thrust of the Commission's proposal is aimed at securities held as book-entries in intermediaries' accounts. For such holdings, the Commission indicates that, first of all, clarity is needed as to the legal nature of the investors' rights arising from such book-entries. Equal importance is given to the legal framework governing transfers of rights in respect of securities held in this way. This includes clarity in determining the exact time when these rights are transferred, an element that is particularly crucial in cross-system and cross-border transactions, where mismatches could lead to losses. Other issues highlighted include determining the priorities of competing interests and the prevention of upper-tier attachments, in particular if securities are pooled in omnibus accounts and if an upper-tier attachment would have the effect of freezing all the securities recorded in the account where the attachment is made, and not just those of the investor concerned.

The other two issues listed have not previously figured among the legal issues identified by the Giovannini Group. Yet, given the strong legal implications of the underlying topics, the Commission decided to include the analysis of these related legal problems in the Legal Certainty Project.

The first of these issues concerns differences in national laws affecting corporate action processing, which refers to the differences in Member States' laws as to the determination of the exact moment when a purchaser is considered as becoming the 'owner' of a security, for instance for the purpose of paying dividends. Under existing legal regimes, this can be the trade date, the intended settlement date or the actual settlement date. Such discrepancies may inhibit the centralisation of securities settlement and, for this reason, constitute a barrier to further integration. As a consequence, the Commission considers that the relevant rules may need to be harmonised.

Finally, the Commission wishes to consider in more detail the issue of securities location, thus responding to suggestions from market participants that restrictions relating to an issuer's ability to choose the location of its securities are a further barrier to consolidation. The basis for these restrictions can be found either in national securities laws, linking listing in a particular market with the use of the local CSD, or in company laws. The Commission intends

188 Ibid., p. 25.

189 Investors' ownership rights, protection from insolvency of the intermediary, tradability, protection for acquirers, and investor protection.

to consider this issue further, taking into account the differences between the various types of securities as well as the company law implications of such requirements.

The core of the Legal Certainty Project is a group of legal experts (the Legal Certainty Group) established in January 2005[190]. The Group is mandated to analyse issues of legal uncertainty relating to the integration of EU securities clearing and settlement systems, and to advise the Commission accordingly. In doing so, it is required to consider the legal barriers to integration and to evaluate and, if necessary, to propose methods for harmonising national laws and/or procedures. The Group is chaired by the Commission[191], with the secretarial functions being provided by the Directorate-General Internal Market and Services. The Group is made up of around 35 legal experts, reflecting the legal traditions of all 25 Member States. The composition of the Group is intended to capture a wide range of relevant expertise, so that its members, who sit in a personal and non-representative capacity, are drawn from academia, the public and the private sectors[192]. The group met three times in 2005, and further meetings are planned.

The Commission has not set a time limit on the activities of the Legal Certainty Group, but taking into account the overall clearing and settlement project, a medium-term horizon of two to three years seems likely. Neither the Second Communication nor the Group's mandate prescribes a specific outcome. Whether the Group will recommend any legislative action will depend on its assessment of the problems inherent in the legal infrastructure for clearing and settlement in the EU, which should also entail an evaluation of the legal barriers identified in the Second Communication.

So far, the Group has conducted a stock-taking exercise of the existing legal infrastructures in the 25 Member States on the basis of a detailed questionnaire[193], to be used in support of its analysis. Also, a number of selected topics have been addressed in specific research notes, dealing with issues such as the current EU regulatory regime, dematerialisation of securities in the EU, the interaction of clearing and settlement with company law, concepts of finality, the relevance of derivatives, and the specificities of the Nordic systems. Currently the Group is preparing its first report, addressing in particular seven core issues[194] that have been identified as constituting the main source of legal barriers to cross-border clearing and settlement in the EU. The core issues are:

190 'Financial services: Commission sets up expert group on legal certainty issues in clearing and settlement', Commission press release, 1 February 2005.

191 The Chairman is Pierre Delsaux from the Commission's Directorate-General Internal Market and Services.

192 All relevant documentation and a list of the members may be found under the group's website: http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm.

193 http://www.europa.eu.int/comm/internal_market/financial-markets/docs/certainty/questionnaire-31012005_en.pdf.

194 Cf. CESAME, Synthesis Report of the meeting held on 25 October 2005, p. 14 et seq.

(1) Scope of application

This topic will outline the scope of the harmonisation exercise, by providing e.g. definitions of securities or securities accounts, as well as by describing the personal scope of application.

(2) Legal effects of a book-entry

Any harmonisation measure would have to specify the exact nature of the rights constituted by book-entries. There should be clarity as to their effects, in other words whether a book-entry is constitutive for the acquisition or disposal of title, or whether it merely has an evidential function, recording an entitlement that has already been acquired. While either method may be perfectly viable on a domestic basis, the interaction of different legal mechanisms may pose legal difficulties, for instance where there is a longer holding chain involving intermediaries providing securities accounts which are governed by different laws.

(3) Corporate actions and voting rights

The connection between the proprietary rights in indirectly held securities and the company law treatment of rights in respect of securities may have to be clarified. This could entail specifying the details for acquiring and exercising such rights, in particular as regards the exercise of corporate actions and shareholders' rights.

(4) Recognition of the status of indirect (and direct) holdings

One of the major problems arising from the current diversity of legal systems is the degree of interoperability between systems where rights are based on indirect holding of securities, and those where rights are based on the direct entitlement of the investor in the underlying securities. These structures can vary considerably. Indirect holding systems (e.g. those where securities are held in pooled omnibus accounts with an intermediary, who is recorded as account holder or nominee on the next (upper) tier) provide account holders with legal positions that differ greatly from those in jurisdictions where either the position of investors has to be recorded directly with a central securities depository, or where the law provides that only the (ultimate) investor acquires a legal status in respect of securities, irrespective of how many intermediaries (acting only as accountants of the investor's positions) are involved in the holding chain. A lack of interoperability or uncertainty about the legal position of investors and intermediaries could result in risks and barriers to business.

(5) Transfer requirements

The legal and operational steps required to make transfers of holdings in securities effective between parties and against third parties differ significantly from jurisdiction to jurisdiction.

(6) Moment of transfer

The question of the precise moment when an entitlement passes from transferee to transferor is connected with the transfer requirements. Certainty about and, to some degree, harmonisation of such timing are prerequisites for settlement finality purposes, and possibly for determining the allocation of shareholders' rights. If the moment of transfer differs (e.g. in back-to-back securities transactions) this could even lead to the creation of excess securities, if a transferee acquires rights in one jurisdiction, which the transferor has not yet relinquished in another jurisdiction. Some consideration may have to be given to the possibility and effect of conditional transfers, which are relevant for ensuring delivery versus payment (DvP) mechanisms and reversals of transfers.

(7) Priority rules

Specific attention will have to be paid to the possible need to harmonise rules on the priority of rights in indirectly held securities. This entails clarity in the ranking of competing rights, claims or of statutory or contractual liens, as well as the conditions which apply to the acquisition of rights in securities in good-faith. In all these circumstances, a common understanding might have to be reached as to whether prior rights or the most recent transaction will prevail. Furthermore, the extent of the liability of an intermediary will have to be clarified. Finally, the rules on the allocation of shortfalls (for instance a pro rata sharing) will have to be addressed.

Once the report has confirmed the existence and extent of the legal problems, the Group will consider adequate responses including, if appropriate, proposals for legislative action in the form of a directive, a regulation or soft law. The proposals, if any, will then have to be endorsed by the Commission and the Member States.

The establishment of the Legal Certainty Group is evidence of the Commission's strong commitment to removing the legal barriers to an integrated EU infrastructure for clearing and settlement. However, the task is far from easy. The current legal framework in the EU, both at Community and at Member State level is a moving target, as it includes both ongoing

legislative reforms in a number of Member States[195], and current initiatives at Community level[196]. Any solutions proposed must address the challenge that, given the highly technical and sophisticated nature of clearing and settlement, there is a need for precise and balanced provisions. In its proposals, the Group will have to take into account the potential impact of its suggestions on the general property law, company law and insolvency law regimes of the Member States. It will also have to ensure consistency with existing Community legislation (e.g. the Settlement Finality Directive and the Collateral Directive) and take account of the need for the global compatibility of a European solution. However, the Group can build on the foundations that have already been laid by other groups, both at European[197] and international levels. As to the latter, the parallels between the current European initiative and the work currently being undertaken by UNIDROIT on harmonising substantive rules regarding securities held with an intermediary[198] provides a unique opportunity for mutual inspiration which will ideally result in a globally consistent and compatible regime.

V. INTERACTION WITH INTERNATIONAL INITIATIVES

(a) Interaction with UNIDROIT

'UNIDROIT' is the short name for the International Institute for the Unification of Private Law. UNIDROIT is an independent intergovernmental organisation whose purpose is to study needs and methods for modernising, harmonising and coordinating private and in particular commercial law as between States and groups of States. 60 countries are currently member states of UNIDROIT, including all EU Member States except Lithuania.

On 23 December 2004, UNIDROIT released a 'Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary' (the 'draft Convention'), together with explanatory notes[199]. The draft Convention and the explanatory notes are the work of a Study Group[200] set up in 2001 to study the possibility and scope of a future international instrument capable of improving the legal framework for securities holding and transfer, with a special emphasis on cross-border transactions.

The goal of the Study Group is twofold, first to promote the internal soundness of countries' legal frameworks for the holding and disposition of securities held through intermediaries,

[195] E.g. the initiatives of the Financial Markets Law Committee in the United Kingdom, 'Analysis of the need for and nature of legislation relating to property interests in investment securities, with a statement of principles for an Investment Securities Statute' (2004), www.fmlc.org.

[196] E.g. on shareholders' rights.

[197] For instance, the EFMLG report, 'Harmonisation of the legal framework for rights evidenced by book-entry securities in respect of certain financial instruments in the European Union', June 2003, www.efmlg.org.

[198] Cf., in particular, the UNIDROIT 'Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary', November 2004, together with the related explanatory notes and preparatory papers, http://www.unidroit.org/english/workprogramme/study078/item1/main.htm.

[199] Cf., the UNIDROIT 'Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary', November 2004 together with the related explanatory notes and preparatory papers.

and second to ensure cross-border system compatibility between jurisdictions. As in the Legal Certainty Project, the effectiveness of book-entry transfers and the finality of transfers made by book-entry debits and credits are seen as being crucial for reducing uncertainty and systemic risk. The Convention will be negotiated in a series of meetings, and the first meeting of a Committee of Governmental Experts took place in May 2005[201], with at least two more meetings being planned in 2006.

The draft Convention focuses on book-entry accounts. The core concept is a bundle of rights resulting from the crediting of securities to a securities account, termed 'intermediated securities'[202]. Based on this concept, the minimum characteristics for the acquisition and disposition of such intermediated securities (whereby no correspondence between a credit and a debit entry on securities accounts is required), as well as for the establishment of security interests therein, are established. It deals with the rules on certain effects of book-entry transfers (in the Convention's terminology 'effectiveness', the term 'finality' is not used) and reversals thereof. Further provisions deal with the prohibition of 'upper-tier attachments', priorities among competing interests, and the protection of an innocent (the term 'good faith' is not used) acquirer from adverse claims. Finally, it specifies the rights of the account holder and the responsibilities of the intermediary in the event of insolvency; establishes a regime for loss allocation based on *pro rata* loss sharing; addresses the treatment of corporate actions and voting rights; and clarifies the legal relationship between a collateral taker, an intermediary and an account holder, in situations where the account holder provides its securities as collateral (following the principles of the Collateral Directive).

There is considerable overlap between the UNIDROIT project on harmonised substantive rules regarding securities held with an intermediary and the Legal Certainty Project, as well as with the Settlement Finality Directive and Collateral Directive. This is recognised by the mandate of the Legal Certainty Group, which is asked to liaise with and follow closely the activities of UNIDROIT[203]. Furthermore, the Council has granted the Commission authority to negotiate, on behalf of the Community, those parts of the UNIDROIT draft Convention that affect existing

200 Cf. UNIDROIT Study LXXVIII Doc. 8, Position Paper on 'Harmonised Substantive Rules Regarding Indirectly Held Securities', August 2003.

201 Cf. the summary report of the May meeting http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-23-e.pdf.

202 Cf. the latest version of the UNIDROIT 'Preliminary draft Convention on harmonised substantive rules regarding intermediated securities', June 2005, http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-24-e.pdf.

203 Close liaison is ensured by the fact that about half the members of the Legal Certainty Group also participate in the Unidroit project.

EU law, with particular emphasis on issues covered by the Settlement Finality Directive and the Collateral Directive[204].

The draft Convention is still at a preliminary stage and may also be aimed at less developed markets. Thus it is not yet clear whether it will provide suitable solutions to EU issues. However, the parallels between the work currently being undertaken by UNIDROIT and the EU Legal Certainty Project provide a unique opportunity for mutual inspiration which will ideally result in a globally consistent and compatible regime.

(b) Interaction with the Hague Conference on Private International Law

Another global initiative is the work of the Hague Conference on Private International Law (the 'Hague Conference'). The Hague Conference is an inter-governmental organisation, founded by the Dutch Government in 1893, the purpose of which is 'to work for the progressive unification of the rules of private international law'. Currently, 65 states are members of the Hague Conference, including all 25 EU Member States.

On 13 December 2002, the member countries of the Hague Conference finalised the drafting of a 'Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary' (the 'Hague Convention')[205]. The Hague Convention was prepared by a fast-track procedure, with only three expert meetings held between January 2001 and December 2002. The process attracted the strong interest of globally active custodian banks and international industry associations.

The Hague Convention is intended to establish a universally applicable conflict of laws regime that would determine, with *ex ante* certainty, the applicable law for proprietary and related rights resulting from the holding, transfer and collateralisation of indirectly held securities, in other words for those substantive legal issues currently being addressed by the Legal Certainty Project and UNIDROIT. The primary rule[206] is based on the principle that the parties to an account agreement can contractually choose the law of the state which shall govern all the proprietary rights related to securities held on such securities account, provided that the intermediary has an office engaged in a business in the state chosen or has some other regular activity of maintaining (any) securities accounts there. Consequently, the Hague Convention is incompatible with the existing conflict of laws rules in the financial *acquis*

[204] Commission press release 'Commission granted authority to negotiate international convention on holding securities', 20 December 2005.

[205] Hague Conference on Private International Law, 'Convention on the Law Applicable to Certain Rights relating to Securities held with an Intermediary', 13 December 2002, www.hcch.net; cf. also Goode/Kanda/Kreuzer, *Explanatory Report on the Hague Securities Convention*, 2005.

[206] Cf. Hague Convention, Article 4.

communautaire[207], which are based on the principle that the law of the state where the relevant account is maintained governs the specified substantive law issues. Thus, signing and ratifying the Hague Convention would necessitate prior amendment of the corresponding provisions in the *acquis communautaire*.

On 15 December 2003, the Commission proposed that the Community should sign the Hague Convention[208]. At present the Council is still considering whether to sign the Convention, in view of a number of legal and economic concerns that have been raised by some Member States and the ECB[209]. In respect of the legal concerns, in June 2005, the Council requested the Commission to undertake a study of four specific legal issues, namely: a) the Convention's scope of application; b) its effect on third parties' rights; c) its impact on substantive and public law (in particular concerning insolvency, market abuse and money laundering); and d) the effect on a diversity of laws on settlement systems and prudential regimes. Taking into account the findings of the Commission, the Council will then decide whether or not to go ahead and sign the Hague Convention.

The Hague Convention has been the subject of intense academic debate. The weighing of the arguments for and against the Convention has generated a debate which sometimes bordered on the polemic[210]. While, indisputably, the Convention would provide globally active custodians with new flexibility to customise their securities transactions, public policy considerations such as systemic stability and regulatory control of risks might suggest a restriction or even prohibition of the free choice of law by the parties at least in specific circumstances. In any case, as was clearly spelled out by UNIDROIT[211]:

207 I.e. the Settlement Finality Directive, Article 9(2); the Collateral Directive, Article 9; and the Winding-up Directive for credit institutions, Article 24.

208 Proposal for a Council Decision concerning the signing of the Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary (COM(2003) 783 final), http://europa.eu.int/comm/internal_market/financial-markets/hague/index_en.htm.

209 ECB Opinion CON/2005/7 of 17 March 2005 at the request of the Council of the European Union on a proposal for a Council decision concerning the signing of the Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary (COM(2003) 783 final), (OJ C 81, 2.4.2005, p. 10).

210 Cf. e.g. Rank, 'Vaststelling Hague Securities Convention: meer rechtszekerheid in het internationale effectenverkeer?', *NjPR* 2005, p. 249; Deguée/Devos, 'La loi applicable aux titres intermédiés - l'apport de la Convention de La Haye de décembre 2002', *Revue du droit commercial belge* 2006 ; Germain/Kessedjian, 'La loi applicable à certains droits sur des titres détenus auprès d'un intermédiaire. Le projet de convention de La Haye de décembre 2002', *Rev. crit. dr. intern. privé* 2004, p. 49; Reuschle, 'Grenzüberschreitender Effektengiroverkehr', *RabelsZ* 2004, p. 687; Girsberger/Guillaume, 'Aspects de droit international privé du transfert et du nantissement des papiers-valeurs et des droits-valeurs détenus dans un système de dépôt collectif', *Journée 2003 de droit bancaire et financier* 2004, p. 15; Löber, 'Die Haager Konvention über das auf bestimmte Rechte an verwahrten Wertpapieren anwendbare Recht', *BKR* 2003, p. 265; de Vauplane/Bloch, 'Loi applicable et critères de localisation des titres multi-intermédiés dans la Convention de La Haye', *Mélanges AEDBF-France* IV 2004, p. 469; Kreuzer, 'Das Haager Übereinkommen über die auf bestimmte Rechte in Bezug auf Intermediär-verwahrte Wertpapiere anzuwendende Rechtsordnung', *Le droit international privé: esprit et méthodes, Mélanges Paul Lagarde* 2005, p. 523; Haubold, 'PRIMA – Kollisionsregel mit matriellrechtlichem Kern', *RIW* 2005, p. 656. See also the detailed comments in the ECB opinion on the Hague Convention. For an example of the latter category of contributions: Bernasconi/Sigman, 'Myths about the Hague Convention debunked', *IFLR* November 2005, p. 31.

211 UNIDROIT Position Paper on harmonised substantive rules regarding indirectly held securities, August 2003, p. 11.

> '… to solve conflict-of-laws issues would not be enough. While clear identification of the applicable law does eliminate an important area of uncertainty, the substantive law thus identified may itself be unclear or unsatisfactory. Moreover, individual laws which operate satisfactorily in isolation may fail to combine effectively in the context of the cross-border holding and transfer of securities. A number of instances have been identified where two or more national substantive laws on contract, property and dealing in securities do not properly interconnect and give rise to inefficiency or legal uncertainty.'

Ideally, a decision on the most appropriate conflict of laws regime should be taken as an integral part of a broader law reform, encompassing substantive provisions as well as a compatible conflict of laws rule.

VI. OTHER RELEVANT EUROPEAN INITIATIVES

In addition to the Commission's clearing and settlement project, two further related Community initiatives are worth mentioning.

(a) The Shareholders' Rights Project

The work that the Legal Certainty Group has been mandated to do in relation to corporate action processing directly interacts with the regime for the rights of shareholders of companies. In this respect, the Commission adopted an Action Plan[212] on 21 May 2003, announcing measures to modernise company law and enhance corporate governance in the EU, in which it declared that strengthening the rights of shareholders in listed companies across the Member States was a priority. The scope of this project includes (a) the right to ask questions, (b) the right to table resolutions, (c) the right to vote in absentia, and (d) the right to participate in general meetings via electronic means. These facilities should be offered to shareholders across the EU, and specific problems relating to cross-border voting should be solved. The Commission considered that the necessary framework should be developed in a Directive, since the effective exercise of these rights requires that a number of legal difficulties be resolved.

The Shareholders' Rights Project covers all shares in public companies, whether or not held through intermediaries. The issues it addresses include: entitlement to control and voting rights; dissemination of information in advance of general meetings; admission to and participation in general meetings, as well as the right to ask questions; the right to submit proposals for a decision; and the right to vote *in absentia* and some further issues. Most of the

[212] Commission Communication of 21 May 2003 - Modernising Company Law and Enhancing Corporate Governance in the European Union – a Plan to Move Forward (COM(2003) 284 final), http://Europa.eu.int/comm/internal_market/en/company/company/modern/index.htm.

legal and operational mechanisms in these respects cannot be considered without tackling the issue of modern methods of securities holdings. For instance, the exercise of voting rights based on securities held through intermediaries may require clarity and certainty about the allocation of the rights and obligations between the investor, the intermediary and the issuer, so that the rights vested in shares held through intermediaries are equivalent to rights vested in directly held securities. Legal certainty about the identity of the person controlling the rights vested in the security is a key prerequisite for the securing a shareholder's right to vote in respect of securities held through intermediaries. Moreover, the rights and obligations of intermediaries and issuers vis-à-vis the shareholder play a significant role in the system of indirect holding (in particular those related to the identification and authentication of the person entitled to a security). Certainty in determining the control over voting rights may also be relevant for the clearing and settlement infrastructure, for example in connection with the practice of securities lending, which raises questions for the determination of who controls the voting rightsand other rights of a shareholder. In particular, the Shareholders' Rights Project notes the need for transparency about such agreements and advocates imposing a duty of disclosure on intermediaries in respect of such agreements. Furthermore, in respect of settlement times, the Winter Group[213] has already noted the problem of the possible impact of differences in settlement times on the ability of shareholders to exercise their voting rights when shares are transferred in cross-border transactions. These differences could result in a situation where two investors in different countries are simultaneously regarded as being entitled to the same securities. Alternatively, a situation may arise when there might be a period when no-one is regarded as being entitled to the securities[214].

As a basis for the key elements of a Commission proposal, the European Commission launched two public consultations on facilitating the exercise of basic shareholders' rights in company general meetings and solving problems in the cross-border exercise of such rights[215]. In general, the respondents to the consultation strongly supported the Commission's initiative. A number of respondents also pointed out that a minimum harmonisation of shareholders' rights in relation to the general meeting is necessary in order to achieve a single

213 Http://www.minjust.nl:8080/b_organ/ wodc/publications/ond02_6.pdf.

214 Some sources indicate (e.g. the majority of responses to the preliminary consultation of the Winter Group) that, in practice, differences in settlement times may not cause problems with respect to voting rights. It remains to be assessed whether these are merely incidental or indicate a wider problem with cross-border transactions. Other sources (e.g. International Corporate Governance Network – ICGN, http://www.icgn.org/organisation/documents/cbv/cbv_letter_van_ginkel_may2002.php) indicate that, for the purpose of exercise of the rights, there may be a way of using law to solve the problem of non-harmonised settlement systems by precisely determining the moment of transfer in cross-border transactions involving different standards of settlement time. The viability of such a rule, as well as the potential issues related to its enforcement, remains to be further examined.

215 'Fostering an appropriate regime for shareholders' rights', Commission consultation documents, 16 September 2004 and 13 May 2005, http://europa.eu.int/comm/internal_market/company/shareholders/index_en.htm

EU capital market. Other respondents pointed to the diversity of national company laws and argued that any initiative taken at EU level should be confined to principles, so as to give Member States enough flexibility to implement EU measures in a way that is consistent with their company laws[216].

After having carried out a comprehensive impact assessment, on 10 January 2006, the European Commission published a proposal for a Directive on the exercise of voting rights[217]. The purpose of the proposed Directive is to facilitate the cross-border exercise of shareholders' rights in listed companies, through the introduction of minimum standards. It seeks to ensure that shareholders, no matter where in the EU they reside, can have timely access to complete information and simple means for exercising certain rights, notably voting rights, at a distance. The Commission concludes that the main obstacles to cross-border voting for investors are the requirement to block shares before a general meeting, difficult and late access to information that is relevant to the general meeting and the complexity of cross-border voting, in particular proxy voting. It proposes the following minimum standards:

- general meetings should be convened with at least one month's notice. All relevant information should be available on that date at the latest, and posted on the issuer's website. The meeting notice should contain all necessary information;
- share blocking should be abolished and replaced by a record date system which should be set no earlier than 30 days before the meeting;
- the right to ask questions should be accessible to non-residents. The maximum shareholding thresholds to benefit from the right to table resolutions should not exceed 5 %, in order to open this right to a greater number of shareholders while preserving the good order of general meetings;
- proxy voting should not be subject to excessive administrative requirements, nor should it be unduly restricted. Shareholders should have a choice of methods for distance voting; and
- voting results should be available to all shareholders and posted on the issuer's website

216 Synthesis of the comments on the second consultation document of the of the Directorate-General Internal Market and Services: 'Fostering an appropriate regime for shareholders' rights', p. 4, http://europa.eu.int/comm/internal_market/company/docs/shareholders/consultation2_report_en.pdf.

217 Commission Proposal of 5 January 2006 for a Directive on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC, (COM(2005) 685 final), http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2005/com2005_0685en01.pdf.

The proposal has a direct bearing on the work of the Legal Certainty Group, for instance as regards the effects of introducing a record date. Close coordination between the two projects is therefore warranted, in order to avoid mismatches or duplications.

(b) Standards for securities clearing and settlement

Complementing the activities referred to above, there have been ongoing efforts to improve the existing EU framework for the regulation, supervision and oversight of securities clearing and settlement systems and other relevant service providers. To this end, the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) established a joint working group in October 2001, with the European Commission participating as an observer. This working group was mandated to establish common standards or recommendations for securities settlement systems and for central counterparties, and to promote the safety and efficiency of cross-border clearing and settlement activities in the EU. Its work was based on the CPSS/IOSCO recommendations[218], but aimed at adapting these global recommendations to the European environment. It was felt that providing a single consistent set of standards would contribute significantly to creating a level playing-field for the providers of securities clearing and settlement services and to overcoming the significant heterogeneity of the legislative frameworks of the Member States.

The working group consulted the industry and relevant parties through public consultations and hearings[219]. In 2004, the working group finalised a report on 'Standards for securities clearing and settlement in the European Union'[220], which contains 19 standards[221] that are aimed at increasing the safety, soundness and efficiency of securities clearing and settlement systems in the European Union. These standards follow a functional approach, based on risk considerations, as they are intended to apply to operators of securities clearing and settlement systems (whether or not providing banking services), as well as possibly to other entities with a high degree of internalisation of clearing and settlement of transactions, as evidenced by the significance of exposures and risks.

These standards will have no formal effect until an assessment methodology is developed and implemented and an analysis of the impact of the standards has been undertaken. It has not yet been decided which legal format the standards should take upon completion of the assessment methodology. The standards could form the basis of the activities of the

218 CPSS/IOSCO, 'Recommendations for securities settlement systems', November 2001, http://www.bis.org/publ/cpss46.pdf; see also 'Recommendations for Central Counterparties', November 2004, http://www.bis.org/publ/cpss64.pdf.

219 March 2002: Call for contributions from interested parties. August 2003 and May 2004: Launch of public consultations to provide comments on consultative reports containing draft versions of the standards. October 2003 and May 2004: Public hearings with the respondents to the consultations.

220 Related information may be found under www.cesr-eu.org and www.ecb.int.

competent regulatory authorities, and could also be used by the central banks as oversight standards, replacing the existing user standards[222].

VII. CONCLUSIONS

As shown by the above initiatives, the European Union places high priority on overcoming the significant heterogeneity between the legal and operational environments of EU Member States, and on creating a level playing-field for the providers of securities clearing and settlement services in the single market. The stakes are high, as disturbances affecting clearing and settlement in the securities markets may spread to payment systems and to the financial sector in general.

Clear and effective rules supporting the market infrastructure are a prerequisite for building market confidence, fostering investor protection, and limiting and managing systemic risk. In this context, a modern and efficient legal framework will not only enhance the safety, soundness and efficiency of the clearing and settlement of financial instruments, it will also promote the integration and competitiveness of European financial markets.

The Commission's initiatives and the activities of CESAME and of the Legal Certainty Group all recognise that the emerging structures will have to balance all the relevant interests, demands for market efficiency, and the need for adequate investor protection and financial stability, if they are to win the confidence of market players and investors. Thus, all procedures follow the principles of full openness and transparency, giving all stakeholders concerned an opportunity to provide input to this complex exercise.

In the legal sphere, there is an emerging consensus on the basic principles for law reform in the field of clearing and settlement. The emphasis clearly lies on the protection of investors' rights in securities from the insolvency of an intermediary, and on the conditions for the transfer of investors' rights in securities, including the protection of acquirers' rights. The EU projects, and most prominently the Legal Certainty Project, take into account the relevant research that is being conducted by various groups, at EU and at international level, to develop the technical details required to achieve practical solutions. With the aim of achieving global consistency, the UNIDROIT project for harmonised substantive rules regarding securities held with an intermediary[223] could serve as a reference point in this respect.

[221] As regards the legal issues, Standards 1, on a safe and transparent legal framework, 6 on CSD functions, 8 on intraday finality, and 12 on the protection of customer's assets, are particularly relevant.

[222] Standards for the use of EU Securities Settlement Systems in the ESCB credit operations, January 1998, of which Standard 1 (Legal soundness): 'All securities settlement systems (SSS) and the links between such systems must have a sound legal basis, ensuring that the settlement of payment and securities transfers is final, and must provide for adequate protection for the rights of the national central banks and the ECB in respect of securities held in their accounts in such systems', http://www.ecb.int/paym/coll/standards/html/index.en.html.

[223] Cf. in particular, the UNIDROIT Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary, November 2004 together with the related explanatory notes and preparatory papers.

However, given the high level of sophistication of the EU financial markets, a high degree of uniformity may be required for seamless transactions within the European financial system, going well beyond what is required for a general regime aiming at global consistency. Any EU solution will have to take into account the specifics of established market practices and will need to be consistent with the legal and regulatory standards in the Community.

The timing for creating a coherent and consistent legal environment encompassing all aspects of holding and transferring financial instruments, whether outright or as collateral, is very favourable. The schedule for preparing or amending the various Community legal instruments relating to the efficiency and safety of securities clearing and settlement converges during 2006 and immediately thereafter.

In this context, the primary need is to ensure that existing and new legal acts are consistent with each other. Any duplication or mismatch of substantive rules must be avoided. This applies to EU legal instruments already in existence (i.e. the Settlement Finality Directive, MiFID, the Collateral Directive, the Banking Directive, the Capital Adequacy Directive (CAD), etc.) as well as to the parallel current legislative initiatives (in particular the Legal Certainty Project and the Shareholders' Rights Project).

A consolidation and to some degree recasting of the existing EU legal framework may prove to be crucial in removing legal uncertainties and risks. In an ideal world, this would lead to a single set of rules applying to all aspects of the securities clearing and settlement infrastructure. However, in the short to medium term, building on the existing set of EU legal acts, with focused legal acts with restricted scope, is likely to remain the norm. The ongoing process of reviewing existing EU directives could help overcome inconsistencies and allow, to the extent deemed necessary, the identification of possibilities for improving the quality of regulation.

The current review of the Settlement Finality Directive is one of the most obvious cases for reconsideration. As has been shown above, the environment in which systems operate has changed considerably in recent years. Cross-border consolidation and cross-border participation continue to increase, exposing systems to new forms of risk. Clearing houses and central counterparties become more and more relevant. This could warrant introducing provisions in the Settlement Finality Directive to cater for these specific risks. One might even consider to remove securities clearing and settlement provisions from the Directive entirely, if access rules and the definition of clearing and settlement systems and their participants were addressed in a new framework directive for clearing and settlement, while the related insolvency law provisions and finality rules could be covered by future legislation resulting from the work of the Legal Certainty Project and collateral-related provisions could be introduced in the Collateral Directive.

As regards the Collateral Directive, a number of open issues have already been mentioned above which could be addressed in the upcoming review in 2006. Apart from a review of the opt-out clauses and the inclusion of issuer or rating-related top-up collateral arrangements, particular attention could be paid to the netting regime. As the Collateral Directive only addresses a very limited form of netting (bilateral netting in collateral transactions), the need for a broader recognition of netting techniques could be considered, in particular multilateral netting, as used by systems, and central counterparty netting should be addressed, either in the Collateral Directive, in the Legal Certainty Project or in other legal acts (e.g. the Winding-up Directive for credit institutions and the Insolvency Regulation).

As regards the MiFID, it is acknowledged that its focus is on the trading side of securities transactions rather than on their settlement. Yet, to the extent that MiFID provisions have a bearing on the clearing and settlement infrastructure (for instance through rules regarding the access of investment firms to central counterparties and clearing and settlement facilities), it should be ensured that the Directive and its implementing measures are consistent with the access rules of any future framework directive. Furthermore, the solvency related provisions in the Banking Directive and the CAD that have an impact on entities involved in the clearing and settlement infrastructure might also have to be revised in view of the general risk considerations underlying the new regime of a possible framework directive.

The Legal Certainty Project merits particular attention, as it will complement any future framework directive by ensuring a sound and safe underlying legal infrastructure for the clearing and settlement of securities in book-entry form. The core of its focus (in particular the nature of investors' rights, the transfer of these rights, and the finality of book-entry transfers) is clearly distinct from the topics to be covered by a framework directive. However, issues relating to the differences in national legal provisions, concerning corporate action processing and restrictions relating to an issuer's ability to choose the location of its securities, directly interact both with the framework directive and the Shareholders' Rights Project. Thus, close coordination between these legislative processes is required. Finally, the outcome of the discussions of the proposal for the Community to sign the Hague Convention may also have to be taken into account.

Ideally, at the end of the process, there will be a single comprehensive set of rules for clearing and settlement in the EU, fulfilling the demand that

> 'the legal underpinnings of clearing and settlement in the EU should be clear, reliable and coherent' [224]

[224] Commission Communication of 28 April 2004 on Clearing and Settlement in the European Union – The way forward, (COM(2004) 312 final); http://Europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0312en01.pdf, p. 22.

while being globally compatible. The resulting reduction of legal and other risks for cross-border transactions in the 25 Member States would significantly foster the integration and competitiveness of the European financial markets.

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1 "The developing EU legal framework for clearing and settlement of financial instruments" by K. M. Löber, February 2005.

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