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21 January 2011

European Commission Public Consultation on
Legislation on legal certainty on securities holdings and dispositions

EUROCLEAR RESPONSE

1. This response is provided on behalf of the Euroclear group of companies ("Euroclear"). Euroclear comprises the international central securities depository ("ICSD") Euroclear Bank ("EB"), based in Brussels, as well as the national central securities depositories ("CSDs") Euroclear Belgium ("EBe"), Euroclear France ("EF"), Euroclear Nederland ("ENL"), Euroclear UK & Ireland Limited ("EUI"), Euroclear Finland ("EFi") and Euroclear Sweden ("ES"). It also includes Xtrakter, a provider of trade matching and transaction reporting services based in the UK. Euroclear is registered on the European Commission's register of interest representatives (ID number 88290282308-75).

Executive Summary

2. Euroclear supports the initiative to improve the legal framework for account-held securities, as we have long perceived a need for measures to be taken at international level to ease obstacles to, and legal uncertainties surrounding, cross-border securities holdings and dispositions, and in particular cross-border exercise of rights attached to securities. We are particularly glad to see that the proposals in the Consultation Document adopt a broadly functional approach. In addition, we support the policy objective of delivering open access to CSDs by issuers in order to remove Giovannini Barrier 9 and to open up competition between CSDs for the issuers of securities (although this topic is no longer addressed by the Securities Law Directive "SLD" and therefore not addressed by the current consultation).

3. However, there are a number of respects in which, we believe, the proposals require further work in order to achieve their goal of removing obstacles to cross-border holdings and resolving legal uncertainties. We also believe the proposals currently fail to take account of, and make progress in relation to, practical obstacles that have already been identified in the work of ECSDA, among others. In particular:

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3.1. a number of the Principles set out in the Consultation Document attempt to address issues which are not, in our experience, problematic in the cross-border context or which are simply not relevant in that context. In our view, the approach of the Geneva Convention was better-adapted to addressing these issues, and we have concerns that the approach in the SLD appears to differ in a number of respects, not least because this may result in EU account providers being placed at a disadvantage vis-à-vis non-EU providers (see paragraphs 21 and 22);

3.2. the Directive does not, in our view, go far enough in tackling some of the real practical obstacles to cross-border holdings and dispositions that have been identified in other work or through experience. There are incompatibilities in Member States' legislation which create unnecessary obstacles to cross-border holdings such as those which block the use of multi-tiered holding structures or nominee/omnibus accounts (see, in particular, paragraph 79);

3.3. insufficient analysis has been performed of the different categories of function performed by account providers (namely pure account maintenance and securities safekeeping functions[1]) and the different risks they pose. In addition, there are, in our view, some misunderstandings of the manner in which certain securities-holding systems operate at the top tier level (in particular the system operated by EUI, ES and EFi), with the result that some Principles in the Consultation Document apply to certain categories of function or account provider in a way which is inappropriate. In addition, in light of the legal framework for dematerialized securities in France, it is unclear whether the principles will apply at all to EF. Different types of function should not be comprised in a single definition of "account provider" (see paragraphs 6 to 8 and 24 to 26). We believe that by adapting the definitions of these functions (see answer to Question 44 below) systems such as those operate by ES, EFi and EUI can be brought within the scope of the SLD;

3.4. while agreement at EU level on the law applicable to securities holdings is better than no agreement at all, we are strongly of the view that legal uncertainty in this area can only be dealt with adequately at global level, and would support further initiatives at this level (see paragraphs 74 to 78);

[1] For suggested definitions of these functions, see answer to Question 44 below.

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3.5. there is real difficulty with the principles dealing with exercise of rights attached to securities, charges for cross-border services and third-country account holders, as they fail to recognise the realities of securities holding structures in the EU and the constraints EU account providers operate under (see paragraphs 86 to 107);

3.6. in certain areas (notably control agreements) the SLD conflicts with provisions of Member States' law in a manner which will create serious difficulties and substantial costs for affected markets (see paragraphs 57 to 64);

3.7. while we agree that it is appropriate to regulate the function of "account providing" at EU level, we query whether MiFID is the correct basis for such regulation. It does not seem appropriate in particular to bring CSDs within the scope of MiFID when they are soon to become subject to the CSD Regulation (see paragraphs 109 to 111); and

3.8. we urge that the eventual SLD should be consistent with other forthcoming legislation in this area, in particular the CSD Regulation. We note the statement in relation to Principle 1 that EU law should not cover the functions of creation, recording or reconciliation of securities; nevertheless these are a significant part of the functions of most CSDs and it is anticipated that the CSD Regulation will cover them. It is important that the correct rules are located in the correct piece of legislation. In particular we would observe that the SLD is not the correct vehicle for introducing "conduct of business" or similar regulatory provision for CSDs or other types of account provider.

4. We expand on the points above, where necessary, in our answers below to the questions set out in the Consultation Document.

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Question 1: Do you agree that the envisaged legislation should cover the objectives described above? If not, please explain why. Are any aspects missing?

5. Principle 1.1.1 states that "*EU law should regulate the legal framework governing the holding and disposition of securities held through securities accounts and the processing of rights flowing from securities held through securities accounts*." We believe that this aim is too broad and, if delivered, could have significant adverse impacts on some account providers in some jurisdictions. The SLD should focus on the legal difficulties associated with cross-border securities holdings and dispositions, which it should aim to remove or mitigate. The SLD should not contain rules that do not address this aim; more general rules will lead to unnecessary costs for account providers.

6. We agree that the legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities. However, the Directive risks unintentionally impacting the corporate laws of some Member States by failing to cater appropriately for direct holding[2] and transparent systems, such as those operated by EUI and ES, which, as well as providing securities accounts, also have an important role in relation to those laws.

7. This failure results from the fact that the SLD does not distinguish properly between account maintenance functions (such as opening and closing accounts, crediting and debiting accounts and processing instructions in relation to them, which account providers such as EUI and ES certainly do perform and which should, in our view, be covered properly by the provisions of the SLD when performed by operators of direct-holding and transparent systems) and securities safekeeping functions (i.e. functions relating to the actual holding of securities on behalf of an account holder, which providers such as certain CSDs operating a direct holding model (eg EUI) do not perform, except in relation to international/non-domestic securities).

8. We expand on this point in relation to Principles 4 and 14, but we observe here that unintentional impacts on corporate law could be avoided if the SLD were

[2] In this response, we use the term "direct-holding system" to describe a system (such as the CREST system operated by EUI) in which the operator holds no securities on behalf of its members but rather provides a mechanism whereby its members may hold uncertificated securities themselves, thereby entering into a direct legal relationship with their issuer which is not intermediated by EUI.

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drafted so as to distinguish properly between account maintenance and securities safekeeping functions. Such a distinction would also ensure that Principles which are aimed only at securities safekeeping functions do not have an inadvertent and inappropriate impact on account providers which are not performing these functions.

9. We note also that the Principles, as drafted, are not adapted and do not apply appropriately to the system operated by EF. We note that the Principles in the SLD apply uniformly to various intermediaries without taking into account the distinction of functions between them as defined under French law.

10. Under that law, proprietary rights relating to securities are not materialised at the level of the CSD but at the level of the authorized account keepers (custodians) or issuers. The accounts maintained in EF's books are mere technical accounts with no legal value with respect to proprietary rights. As a result, when securities are credited in an account held by EF, proprietary rights in relation to them are determined by the individual accounts opened in the books of the intermediary which is an authorized account keeper (custodian). Transfer of legal title takes place on the latter entity's books.

Question 2: Would a Principle along the lines set out above adequately accommodate the functioning of so-called transparent systems?

11. Principle 2.1 is based on the assumption that, in all instances of holding of "account-held" securities, there will always be a securities-holding function to be performed (and therefore, potentially shared by the account provider with a third party). This is not correct. In the case of direct-holding systems (such as that operated by EUI) the account provider will perform "account maintenance" functions, but unless the account holder is itself holding the securities on behalf of another person (which may or not be the case) there is no scope for performance of a securities holding function. In such a case, there would be no "person other than" the account provider who is responsible for the performance of the "securities holding" functions described in the SLD – and, as a result, the account provider would then be made "responsible" for those functions under the SLD, even though it does not perform them as part of its service offering to its account holders.

12. Therefore while Principle 2.1 is essential to address the concerns of "transparent" system and we certainly support its inclusion in the SLD, it does not address the concerns of direct-holding models (such as that operated by EUI and, in some

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holding scenarios, ES). The SLD should distinguish properly between account maintenance and securities safekeeping functions; this would enable it to apply to the account maintenance functions of account providers such as EUI and ES without, in effect, making them responsible for securities safekeeping functions which they do not perform.

13. In the case of ES, the "person other than the account provider" who is responsible for certain of its functions is the licensed "account operator" which performs book-entry functions on behalf of ES participants or, in some cases, a nominee who holds securities on behalf of its clients in accounts which may include securities held with the CSD, with other intermediaries and in physical form. A proper definition of the "securities safekeeping" function would ensure that the SLD reflects the activities performed by these types of account provider more accurately.

14. We note also that these account operators are already licensed and supervised in Sweden and it is not clear to us that notification to the Commission would bring any additional supervisory benefits.

Question 3: If not, can you explain which aspect is not correctly addressed and what could be improved? What are, if applicable, the repercussions on your business model?

15. See points made in relation to Question 2. In relation to repercussions on Euroclear's business model, please see the points made in response to each question.

Question 4: Do you know of any specific difficulties of connecting transparent holding systems to non-transparent holding systems?

16. Difficulties can arise in both directions. By way of example, when a non-transparent system (as investor CSD) connects to a transparent system, there is a risk that the rules of the transparent system consider the intermediary from the non-transparent system as the ultimate holder of securities. The other way around, when a transparent system (eg as investor CSD) conections to a non-transparent system (as issuer CSD), the investor CSD is by definition an intermediary. Transparent systems often operate in a domestic legal framework which focuses on domestic securities (eg in a dematerialisaion context) and which does not cater expressly or in great detail for the holding of foreign securities by the CSD.

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17. Difficulties can arise for transparent systems (such as ES) where the provisions of national laws governing the non-transparent system mean that the issuer of securities cannot recognise the account holders in the CSD as the holders of the security, for example because those laws only recognise the rights of the person who presents a bearer security, or because they do not recognise omnibus or nominee holdings.

Question 5: Would a principle along the lines described above provide Member States with a framework allowing them to adequately define the legal position of account holders?

18. We support this Principle and broadly agree that it provides an adequate framework for Member States to define the legal position of account holders. We have some concerns about the current drafting of Paragraph (a) of Principle 3.1.1), however. As currently drafted, it appears to encroach on the territory covered by Principle 17. In our view, this Principle should be drafted so as to make clear that (a) account holders should not lose the rights attached to securities purely because they are held in a securities account and (b) that obstacles to recognition of nominee/omnibus holdings are removed.

Question 6: If not, which legal aspects that belong, in your opinion, to an adequate legal position of each account holder could not be realized by national law under an EU framework as described above? What are the practical problems that might occur, in your opinion, if Member States were bound by a framework as described above? What are, if applicable, the repercussions on your business model?

19. See answer to Question 5 above.

Question 7: If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or providers?

20. Yes, this is the case for Euroclear.

Question 7 continued: Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?

21. While measures at EU level may be helpful, in the interests of resolving legal uncertainty in securities markets, which are already global in nature and are

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likely to become more so, we strongly favour the adoption of global measures regarding the substantive law of securities dispositions. We would urge that any EU legislation should not undermine the existing global initiative, namely the Geneva Convention. We are also aware that an EU regime which differs from that eventually adopted at global level could place EU account providers at a disadvantage compared with providers outside the EU.

22. We note a number of significant divergences of approach between the Convention and the SLD in its current form, in particular the following:

22.1. the provisions in the Convention on facilitation of exercise of rights attached to securities did not focus to any extent on persons in the position of the ultimate account holder (referred to in the Convention as "investors") and instead prescribed that certain rights of the account holder could only be exercised against the "relevant intermediary" (i.e. the account provider who maintains the securities account for the account holder) (see article 9(2))[3]. Further, article 10(3) of the Convention made clear that the "relevant intermediary" is not required to take any actions not within its power. This contrasts with Principle 17 which places onerous and unrealistic obligations on the account provider of the ultimate account holder (see further discussion below). In our view, the Convention approach is more reflective of the realities of current securities-holding structures, and more likely to achieve concrete benefits for account holders;

22.2. the Convention recognises the primacy of the agreement between account holder and provider (or, alternatively, the rules of a securities settlement system) in governing the liability of the account provider in relation to the performance of its services (see article 28(3)). This may be contrasted with, for example, Principle 4.1.4 or Principle 17 of the SLD, which prescribe absolute statutory liabilities which cannot, or can only to a limited extent, be mitigated by contract;

22.3. the Convention adopts a more functional approach to definitions of key concepts which is, in our view, preferable in certain respects to that adopted in the SLD (see answers to question 43 below);

[3] The Convention Commentary explained its reasons for this approach as follows; "*Regulating the legal position of account holders, not of investors, is the only choice compatible with the functional approach … and avoids any unnecessary interference with company law and the law of financial markets. Making the operation of the provisions of the Convention depend on the distinction between investors and other account holders would have raised insurmountable difficulties in accommodating the wide diversity of legal systems with which the Convention is intended to interact,*" (paragraph 9-5). We commend this reasoning.

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22.4. the Convention states explicitly that it is not intended to determine whom the issuer must recognise as the person entitled to receive rights attached to the securities (see article 8(2)) which is, in our view, helpful;

22.5. the Convention does not attempt to define an exhaustive list of circumstances in which an account provider may credit a securities account (an exercise which risks failing to capture some circumstances where credits ought to be permitted, as we discuss further in our response on principle 4); and

22.6. the Convention does not prioritise interests created by earmarking over interests created by control agreement.

Question 8: Would a principle along the lines described above allow for a framework which effectively avoids that more securities are credited to account holders than had been originally issued by the issuer?

Question 9: If not, how could a harmonised EU framework better guarantee that account providers do not create excess securities by over-crediting client accounts (keeping in mind that all account providers are either banks or MiFID-regulated entities)? Please distinguish between regulating the account providers' behaviour and issues relating to the effectiveness of excess credits made?

23. We support the objective of this Principle, and we think it is right that the SLD does not aim to introduce a "no credit without debit" principle. However there are dangers in attempting an exhaustive list of the circumstances in which a credit should be permitted, chiefly that the list will not capture circumstances which ought to be covered, and will therefore fail to capture all circumstances in which erroneous credits should be corrected. For example, how does this list relate to the creation of security interests by the operation/effect of law ?

24. In particular, this Principle, as drafted, is based on the premise that credits will only be made where the crediting account provider holds securities on behalf of its members (whether via another account provider, with the issuer, or in physical form). This premise is not accurate in the case of a direct-holding model CSD such as EUI.

25. EUI, as discussed above, provides a mechanism by which UK, Irish, Channel Island and Isle of Man securities may be held directly by its account holders.

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When securities are issued by issuers into the CREST system, and when trades in those securities are settled in the system, EUI can (indeed, if certain conditions are satisfied, it must) make credits to the relevant CREST accounts, but it does so on the basis of no independent holding of securities outside the system. This does not, of course, exclude the possibility that erroneous credits can be made; they can, and EUI should be required (and is required under current law) to correct them. As the SLD stands, however, it excludes the possibility of a system such as that operated by EUI making credits to its accounts, and therefore its proposals for correction of errors cannot sensibly be applied to such a system.

26. In our view, if it is thought necessary to enumerate a list of circumstances in which credits are permissible, other circumstances will need to be included (to cover, for example, the position of EF which credits securities accounts of its participants on the basis of holdings in its own so-called issuance accounts, which represent the entirety of the securities in each issue) and the application of the list ought to be confined to circumstances where the account provider is performing securities safekeeping functions. This will tackle the evil that the Principle aims, rightly, at dealing with, namely potential imbalance between securities held by the safekeeping account provider and credits made to its accounts. Where an account provider is, like EUI, performing account maintenance functions only, it could be made subject to simple obligation to correct erroneous credits (and indeed debits) but the actual circumstances in which credits are permissible do not, in our view, need to be prescribed.

27. We would also point out that applying this Principle to the securities safekeeping function in the cross-border environment results in a situation where clients' accounts cannot be credited until any re-alignment process with the other CSD has been finalised (which may, in our experience, take some days). While of course we acknowledge that errors in such processes resulting in an inadequate amount of securities being held by a CSD will mean that steps must be taken to correct the imbalance, a prohibition on credits being made until such processes have concluded will have a very detrimental impact on settlement efficiency.

28. We should also point out that the assumption in Question 9, that account providers are all banks or MiFID-regulated entities, is not correct. CSDs fall within neither category (but are expected to be regulated in their own right under the CSD Regulation – see our response to Questions 41 and 42 below).

29. Finally, we note that the Principle allows for national law to allow for acquisitions and dispositions to take place by certain methods additional to crediting and

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debiting. We would caution against the creation of closed list of circumstances in which Member States may permit acquisitions and dispositions, since not only does this limit their ability to respond to future technical developments, it means that some methods by which acquisitions and dispositions are currently permitted to take place will not be recognised.

30. For example, we are concerned that this Principle should permit the continuation of the current position under Finnish law, whereby certain interests in securities held in EFi must, in order to be effective, be registered on the account. When registration has taken place the securities may not be disposed of to another account. This system of registration is an important means by which the holders of interests in securities are protected and national law should, in our view, be permitted to preserve it. By way of further example, Dutch law has been drafted with the aim of creating a high degree of flexibility and any administrative entry reflecting that the transferee of securities has obtained rights in them will suffice for acquisition. We see no reason why Member States should not be permitted to maintain this degree of flexibility if they wish.

Question 10: Is the principle relating to the passing on of costs of a buy-in appropriate? If not, in which way should it be changed and why? What would be the repercussions on your business model?

31. The buy-in rule is not adapted to the particular situation of CSDs when they act as issuer CSD/top-tier and any EU legislation must include an exception for this scenario. The comments below therefore only relate to situations where the CSD acts as an intermediary account provider.

32. As regards reversals as a remedy, please refer to the comments below and our extensive response to the European Commission's 2009 consultation on Legislation on legal certainty of securities holding and disposition (the "2009 consultation").

33. This Principle places the account provider under an absolute liability to rectify the consequences of a discrepancy, even where it occurs as a result of the fault of another account provider in the chain of holdings. Further, it severely restricts its ability to pass on the resulting costs to its clients. It is our view that while it is appropriate to require account providers to use reasonable care and skill in selection of custodians and others who hold securities on behalf of their account holders and to have appropriate procedures in this area, it is inappropriate to make account providers strictly liable for the default of other account providers in

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the holding chain. Account providers should be able to pass on the costs of any measures to rectify imbalances onto their account holders, except insofar as they are necessary as a result of the account provider's negligence or willful default.

34. The imposition of this strict liability is likely to change the risk profile of account providers substantially. This may well cause concerns for domestic regulators and be incompatible with the risk profile of providers of market infrastructure services. It is by no means clear that account providers will be able to purchase insurance to cover them for this risk. It is also likely to increase the costs inherent in the provision of certain services substantially.

35. From Euroclear's perspective, this Principle increases the risks and costs inherent in the provision of international services to an unviable level. The value of international securities held via CSD links is in some cases extremely large and a risk of this magnitude would not be tolerable to the CSD from a business perspective.

36. If this Principle were to come into force, therefore, CSDs may have no alternative but to cease provision of their cross-border service as they do not have the risk profile to absorb the liability that could result from this Principle. If this pattern is repeated elsewhere, the SLD may have the effect opposite of that which it intends i.e. it may actually limit cross-border holdings and dispositions of securities.

37. We are also concerned that mandatory reversal/"buy-in" solution will not be sufficiently flexible to take account of the range of circumstances which might lead to discrepancies between securities held and securities credited. We mention above that cross-border transactions often involve re-alignment issues. If such an issue causes a discrepancy, the Principle suggests that the account provider should rectify it "promptly" by either reversal or buy-in. What then happens if the re-alignment issue is resolved? Should the account provider absorb any excess bought-in securities? We would favour instead a simple requirement that account providers, when performing securities safekeeping functions, should have appropriate procedures to deal with discrepancies.

Question 11: Would a principle along the lines described above provide Member States with a framework allowing them to determine legal effectiveness and ineffectiveness to an extent sufficient to safeguard basic domestic legal concepts like e.g. the transfer of property?

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38. We welcome the fact that Principle 5.1.3 recognizes the specific situation of securities settlement systems by giving paramountcy to the rules of the system to determine the consequences of an imbalance in securities held under a securities safekeeping scenario.

39. In this context, it is important to distinguish between actual settlement in the CSD and "contractual settlement" on the books of the account provider which is a member of the CSD. Members of CSDs which act as account providers to other holders often use "contractual settlement", whereby entries in their accounts reflect the result of transactions actually settled in the CSD and unsettled transactions. The legal effect of contractual settlement varies depending on the provisions of the contract between account holder and provider. However account providers should be required to ensure that the securities of one client are not used to satisfy the entitlements of another client under contractual settlement.

40. We also wonder how this Principle will apply in the French context, where accounts in the CSD do not evidence legal rights in relation to the securities held. According to French law, EF's rules determine the settlement date for a transfer of ownership but cannot determine the validity of a transfer since legal rights are not held on its books but on those of the authorized account keeper.

Question 12: If not, please specify how and to what extent national legal concepts would be incompatible. Please specify the practical problems linked to these and, if applicable, the repercussions on your business model.

41. By way of example, in the UK, the Uncertificated Securities Regulations 2001 ("the USRs"), which govern the operation of the CREST system (operated by EUI), include a requirement that the CREST system must respond only to "properly authenticated dematerialised instructions" ("PADIs") and sets out prescriptive requirements in relation to PADIs. The requirement in Principle 5, that no steps further than those set out in Principle 4 should be required to render and acquisition/disposition effective, conflicts with this requirement.

42. If Principle 5 became law, therefore, the USRs would, in this respect, have to change. While it is by no means a given that the USRs should continue indefinitely in their current form, we would point out that they do represent a balance of interests; the requirements around PADIs are prescriptive and difficult for the operator (i.e. EUI) to comply with, but providing it does so, its risk in operating the system is, by reason of other provisions in the USRs, kept low. If the USRs were to change in this fundamental respect this balance might also be

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altered, and EUI would have to consider whether it was comfortable operating the system on the new basis.

Question 13: Would a principle along the lines described above provide for a framework allowing effective protection of client securities in case of insolvency of an account provider?

Question 14: If not, which measures needed for effective protection could not be taken by Member States under the proposed framework?

43. We support Principle 6 and we agree that it will provide an effective framework for protection of client securities.

Question 14 (should be 15): Is the list of cases allowing for reversal complete? Are cases listed which appear to be inappropriate? Are cases missing? What are, if applicable, the repercussions on your business model?

44. The specific circumstances in which reversals may be necessary evolve as the market itself evolves (e.g. reversal by an issuer/its agent of the consequences of a corporate event in which errors were made) and operational errors are, by definition, unforeseeable. We would therefore argue against a prescriptive list of circumstances in which reversals are permissible.

45. In addition, any list of reversal conditions will, by definition, be limited to the EU, thus creating a situation where the circumstances in which an EU account provider can reverse transactions will be limited by law, whereas account providers in the holding chain outside the EU are not subject to such restrictions. This may lead to a situation where the EU account provider cannot take action to reconcile its position held at a non-EU account provider with the holdings of its clients.

46. As discussed extensively in our response to the 2009 Consultations, we agree that any principle on reversals ought to be made subject to the rules of a securities settlement system. In the UK, for example, the circumstances in which the securities settlement system (the CREST system) may reverse transactions is very limited by reason of provisions in the USRs, which creates a level of certainty which the UK market has developed in reliance on. We would suggest that the concept of "rules of a securities settlement system" should therefore be defined to include legislative as well as contractual provisions (see answers to Question 44 below).

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Question 15: Should national law define the extent to which general consent to reversal can be given in standard account documentation? What are, if applicable, the repercussions on your business model in case your jurisdiction would take a restrictive approach to this question and limit the possibility of general consent to reversal?

47. We do not see the value of national law defining the extent to which general consent can be given.

48. As stated above, the circumstances in which reversals might be necessary will change as the market evolves, and they cannot easily be captured in legislation. Certainly in the case of securities settlement systems, the circumstances in which reversals are permitted should be left to their rules and the contractual arrangements or operating procedures they agree with their clients. Further, agreements between CSDs and other account providers relating to reversals must be valid.

49. Question 15 appears to assume that there will always be an agreement between an account provider and its account holder. This is not the case for ES, where accounts are created by law and ES and its account operators do not have agreements with account holders. There may be a need for such agreements in future for several reasons, but we believe this requires further discussion and in any event allowance will have to be made for accounts which have already been opened in the absence of direct agreements.

Question 16: Do you agree with the "test of innocence" as proposed "knew or ought to have known"? Do you know of any practical obstacle that could flow from its application in your jurisdiction? What would be the negative consequences in that case?

50. While the test proposed seems to us a fair one, it must be balanced against the wider interests of the integrity of securities markets and the realities of securities trading. It is important that account holders can rely on credits to their accounts without conducting investigations into the circumstances in which their account came to be credited – investigations which will be particularly complex in the light of the fact that the SLD does not include proposals which would assist in determining on whom the burden of proof of an "innocent acquisition" should lie, or how uncertainties in this area should be dealt with. We believe, therefore, that the ability to reverse should be limited to the initial credit that was "correctable"

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and should not extend to further debits and credits, thus leading to attempts to reverse whole chains of transactions.

51. A requirement to reverse that went beyond the initial transaction would be subject to 2 significant objections; first, it would have a serious adverse impact on finality of settlement in account providers' books and second, as account-held securities are fungible, it will rarely be possible to trace the securities at issue in a chain of transactions. Given the nature of modern securities markets, with multiple trades taking place per second, the circumstances in which reversal in favour of the "innocent acquirer" will be possible, from a practical point of view, may well be very limited. In most cases, it will actually make more sense for innocent acquirers to seek to vindicate their rights outside the account-holding system (by seeking financial recompense, or restitution of securities of the same type as those at issue).

52. Further, any rule that protected the "innocent acquirer" should also allow for the fact that in some instances, it will be necessary to allow exceptions to the rule to be made to protect the wider interest in the integrity of securities markets.

53. Finally, we note that in some Member States (notably the UK in the case of the CREST system) the protection against reversals is in fact even stricter than the protection of the "innocent acquirer" mandated by this Principle. Such protection forms an important part of the certainty and finality in relation to settlement on which the UK market has come to rely. In our view, Member States who wish to maintain a stricter approach to reversals ought to be allowed to do so. Provided the SLD establishes the protection for the "innocent acquirer", there seems no need to prevent Member States from extending the protection against reversal to a wider class of persons if they so wish.

54. We also refer to the very detailed discussion of the issues related to question 16 in our response to the 2009 Consultation.

Question 17: Will a principle along the lines set out above, under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not "visible" in the securities account? If not, please explain why.

55. We query the rationale for privileging "visible" over "non-visible" interests. It would appear to be based on the assumption that earmarking arrangements are

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always more transparent to third parties than arrangements created by control agreement, but this is not necessarily the case. Very often they are only visible to account provider, account holder and the other party to the arrangement. Substantively, the impact of earmarking and control agreements is the same; this rationale would seem to provide scant justification for depriving Member States of the right to determine priority of interests themselves, in accordance with the practice of their own markets.

56. For example, in EFi and ES, interests which are registered in the system, however created, take priority according to the time of their registration. This contrasts with the UK position, where registration or entry on a securities account is not required for an interest to be effective, or to take priority over an interest created later. In the Netherlands, considerations of good faith may influence the order of priority. In our view, these differences between Member States create few problems and the markets in the respective states have developed in reliance on the prevailing practice. We see no justification for interfering in the discretion of Member States in this area, beyond requiring that priority of interests is well-defined in national law.

Question 18: Have you encountered difficulties regarding the priority/rank of an interest created under a mechanism comparable to a control agreement in the context of a priority contest, or, more generally, in an insolvency proceeding? If yes, please specify.

57. Control agreements are used heavily in the EUI context, as a means for CREST settlement banks to protect their interests when they grant secured credit to CREST members (for further details, see answer to Question 19 below). Where different settlement banks have interests in the same CREST members' securities, it is possible for them to determine priority of their interests by deed. EUI has encountered few problems with such arrangements.

Question 19: Would there be negative practical consequences for your business model flowing from a Principle along the lines set out above?

58. As mentioned above, control agreements have an extremely significant role in the payment system operated by EUI as part of the CREST system. Each CREST member is required to have a settlement bank to make and receive payments in CREST on its behalf. The settlement bank controls its exposure to the CREST member by setting a cap on the intra-day credit it provides to that member and some CREST members are permitted to increase the amount of intra-day credit

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they are given by granting a security interest to the settlement bank, referred to in English legal terms as a "floating charge", over the securities in their CREST account. This floating charge is created by means which would constitute a control agreement under the SLD.

59. Control agreements are thus a crucial mechanism used by CREST settlement banks to protect themselves against their exposure to CREST members. Any legislative provision, such as Principle 9, which might undermine the effectiveness of this protection by subordinating interests created by control agreement to those created by earmarking is likely to have an extremely significant detrimental impact on the level of liquidity granted by settlement banks to CREST members. Recent figures place the level of credit granted by settlement banks in CREST which is secured by control agreement at over £320 billion. A loss of liquidity of this order would have a devastating impact on CREST and EUI, and on the UK market generally.

60. It is difficult to think of any mechanism which could fulfil the role currently played in CREST by control agreements which does not have significant disadvantages. The CREST settlement banks' floating charges have the great advantage of flexibility; on the occurrence of certain events (notably the insolvency of the CREST member granting the charge) they crystallize and are converted to fixed charges over all the securities in the charged account, but until that time the CREST member is free to dispose of the securities in his account and use them in his normal trading and settlement activities. The level of secured credit granted to the member is dynamically calculated on the basis of the value of the securities in the account.

61. The floating charge thus protects the settlement bank's interest but requires no administration once it is set up. Solutions based on repo mechanisms, for example, will be more onerous to administer,[4] given that the settlement bank and CREST member will need arrangements in place to prevent over- or under-collateralisation and deal with corporate action outturns on repo-d securities. They will also have the result that the repo'd securities are, for the period of the repo, not available to the member to use in his normal activities, thus reducing liquidity.

[4] It is likely that the CREST settlement banks would have to set up new teams to administer repo arrangements, at substantial cost.

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62. It should also be noted that introduction of a repo mechanism is likely to result in a substantial increase in transaction costs for CREST members. The highest secured limit in the CREST system not associated with a settlement bank is currently £10 billion. The costs of transferring securities to this value on repo are likely to be substantial; compare the floating charge arrangements, which attract no transactional or administration costs.

63. Our rough estimates suggest that **even if an operational solution less complex than repo could be found to deal with loss of the floating charge arrangements** in the CREST system, the costs to EUI and the settlement banks in terms of system development and changes to the legal arrangements underpinning the CREST payment system would run comfortably into several million pounds. Given that the floating charge arrangements have worked well to date, even in times of substantial market volatility and consequent strain on the system, the imposition of such a cost seems wholly unjustified.

64. We also note that floating charges, while hugely important in CREST for the reasons explained above, are used in many other contexts in the UK. Many creditors will choose to protect their interests using floating charges over securities held by their debtors. Subordinating these interests to interests created by earmarking would require creditors to undertake a wholesale review of their position to ascertain that their exposures are still adequately covered, and to make alternative arrangements if they are not, which is likely to be a very onerous and costly exercise.

65. Finally, while we note that the Principle is not intended to affect adversely the free flow of securities into and out of earmarked accounts (insofar as such flow is compatible with the terms of the earmarking, we are of the view that it should be drafted so as to make explicit that the entry of an earmark on a securities does not prevent the account provider from acting – without explicitly drafted consent - upon instructions sent in relation to that account, insofar as acting on those instructions is compatible with the terms of the earmarking. We are concerned at the potential for uncertainty if this point is not made very clear.

Question 20: Would a Principle along the lines described above pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?

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Question 21: If not, which mechanisms should be available which could not be implemented under a framework designed along the lines described above. Please specify.

66. We are pleased that the SLD has not pursued the option of introducing as a general rule that securities held by an account provider should be attributed to its account holders in the event of the former's insolvency. We also agree that that it should be left to national law to apportion losses amongst account holders.

67. We also agree with the basic principle that securities held on behalf of account holders should not be available to creditors in the event of the account provider's insolvency. We are, however, unclear as to what categories of securities are intended to be caught by this Principle. The wording refers to "securities and account-held securities held by the account provider for its account holders" being unavailable for distribution. How far does this category extend? Does it extend beyond securities in which the account provider retains a proprietary interest and securities held in designated client accounts? The SLD needs to be very clear on this point, or substantial uncertainty will result.

Question 22: Should the sharing of a loss in securities holdings (occurring, for example, as a consequence of fraud by the account provider) be left to national law? Would you prefer a harmonised rule, following the pro rata principle or any other mechanism?

68. We agree that this question should be left to national law. If the basic principle of protection for account holders in insolvency is established, it can be left to Member States to determine the approach to breaches of that principle (which might, in certain circumstances, involve invoking the criminal law, which is not territory the SLD should encroach on).

Question 23: Would a principle along the lines described above provide for a framework allowing the national law to effectively apply restrictions on whose instructions to follow for purposes of investor protection, notably in connection with the envisaged principle contained under section 4 (paragraph 2)? If not, please explain why.

69. We agree that this Principle would provide an effective framework for restrictions on whose instructions to follow. The exceptions to the Principle in Principle 11.1.2 seem broadly appropriate, but we have some concerns in relation to exception d), since the applicable law of the account provider may conflict with the law

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governing a CSD in which the securities are held by the account provider. Further thought needs to be given as to how such conflicts can be resolved; in our view and in the interest of the good functioning of securities settlement systems, the rules of a CSD or securities settlement system should be decisive.

Question 24: Would a Principle along the lines described above provide Member States with a framework allowing them, in combination with the envisaged principle on shared functions, to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.

70. Under Belgian law (which governs EB and EBe), attachment is not allowed on account opened with the settlement system in order to protect settlement efficiency, the integrity of the settlement system and prevent systemic risk. The position is the same for EF, as French law prohibits attachment of accounts maintained by a CSD. This protection has been considered essential for the legal certainty surrounding the local settlement system(s) and the relevant markets have developed in reliance on the assumption that attachment of securities at the level of the settlement system is not possible. We would urge strongly that the position should be preserved.

71. We are also concerned by the fact that the discussion of the background to the Principle at paragraph 12.2 suggest that the role of "account operator" in markets where entities perform that function (e.g. Finland) is not properly understood. The role of the account operator is not insignificant compared to the role of the CSD and there is not necessarily any direct account relationship between the "higher tier account provider" and the account holder. It is important the roles of different types of entity in different markets are properly understood, if true functional regulation is to be achieved.

Question 25: Have you ever encountered, in your business practice, attempts to attach securities at a tier of the holding chain which did not maintain the decisive record? If yes please specify.

72. We have not collected information on this.

Question 26: Would the proposed framework for protecting client accounts be sufficient? Should the presumption that accounts opened by an account provider with another intermediary generally contain client securities become a general rule? If not, please explain why.

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73. We agree that securities held in accounts identified as client accounts should not be capable of being attached by an account provider's creditors. We also agree that where national law contains a presumption that that accounts opened by an account provider with a second account provider contain securities belonging to clients, the relevant Member States should be able to maintain that presumption. Such a presumption does not, however, accord with market practice in all Member States (for example in ES nominee accounts have to be flagged as such, and it thus explicitly clear that they contain only client assets, which may be a far more effective method of client protection), and we do not agree that the proposed rule should become a general rule.

Question 27: Would a Principle along the lines described above allow for a consistent conflict-of-laws regime? If not, which part of the proposal causes practical difficulties that could be addressed better?

Question 28: Would the mechanism of communicating to the client, whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to *ex ante* clarity?

Question 29: Do you agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, say why.

74. We remain of the view that while an EU-based solution to conflicts of laws issues is helpful, global securities markets require a global approach. We do not see how the adoption of a rule at EU level, which will have no force in third countries, will contribute to resolution of conflicts with these jurisdictions, any more than the existence of domestic conflict of laws rules do currently. This is a concern for an international collateral taker such as Euroclear Bank

75. The communication to the client of the branch handling the relationship might contribute to clarity as to the law governing the relationship from the outset, but to a lesser extent than a rule which would state that the applicable law is the law of the state expressly agreed in the account agreement as the state whose law governs the agreement. Certainly the proposed rule will bring very limited benefits in terms of certainty unless the circumstances in which the communication can be disregarded are kept very limited (we would suggest that the only circumstance in which it should be disregarded is where fraud can be established).

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76. We also take the view that the legal nature of account-held securities should be governed by the law applicable to the issuance of the securities. It should therefore be clear from the text that it attempts to establish the legal nature of the relevant book-entry holding and not of the ultimate securities in the issue jurisdiction.

77. The adoption of the principle suggested will also cause particular problems for EUI in its role as issuer CSD for Irish, Jersey, Guernsey and Isle of Man securities. As explained above, under the direct-holding model operated by EUI, the account holder retains a direct legal relationship with the issuer of the securities. Any conflict of law rule based on the place where the account provider has its office or performs administrative functions is unlikely to produce an appropriate result, because the law of that place may not be the same as the corporate law governing the issuer of the securities, with whom the account provider facilitates a relationship.

78. In the case of EUI, the SLD Principle would mean that English law would govern Irish, Jersey, Guernsey and Isle of Man securities admitted to the CREST system. So, for example, English law will become the law governing proprietary issues affecting a shareholder's rights in an Irish company, which result is likely to conflict with Irish company law. Our recommendation is that either a separate conflicts of law rule is developed for direct-holding systems like EUI, or that EUI is expressly excluded from the rule (we note in this regard that Article 1(5) of Hague Convention gave the UK Government the ability to declare that it would not apply to EUI).

Question 30: Would a general non-discrimination rule along the lines set out above be useful? Have you encountered problems regarding the cross-border exercise of rights attached to securities?

Question 31: If applicable, would a Principle along these lines have (positive or negative) repercussions on your business model? Please specify.

79. We have indeed encountered significant problems regarding the cross-border exercise of rights attached to securities, and with setting up cross-border links generally. We are concerned that the non-discrimination rule in Principle 15 does not go far enough in dealing with these problems. In our view, Member States should be placed under a positive obligation to remove rules (such as those which block the use of multi-tiered holding structures or nominee/omnibus accounts) which pose obstacles to setting up of cross-border links or exercise of

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rights on a cross-border basis or which hamper the investor's choice of holding patters of his securities. Only removal of these rules will remove current hindrances to cross-border flows.

Question 32: Is the duty to pass on information adequately kept to the necessary minimum? Is it sufficient? If applicable, would there be any (positive or negative) repercussions of such a Principle on your business model? Please specify.

80. We are pleased that the obligation to pass on information to the ultimate account holder has been limited to circumstances where this is possible, and that it is explicitly recognised that, in holding chains, the obligation on account provider should be to pass information to the next "link in the chain" (i.e. its account holder). This formulation comes closer than previous formulations of this Principle to recognising the reality of securities holding structures in the EU. It is simply not possible, in many instances, for an account provider at an upper tier of the holding chain (such as a CSD) to take steps to identify the ultimate account holder.

81. However, further work needs to be done to define what is meant by "possible" in this context. Passing on certain information might be "possible" but nevertheless costly, onerous and impractical, and impossible to achieve in manner timely enough to permit the ultimate account holder to actually make use of the information in exercising his rights. A preferable term in this regard might be "practicable".

82. The Principle does not (at least, not explicitly) recognise the fact that entitlements to exercise rights of holders further down the chain can, in most Member States[5], only be established starting at the level of the issuer CSD, since it is only at this level that a view can be taken on the total holdings outstanding. Therefore, for corporate actions generally, the current information flow from issuer to issuer CSD, which determines entitlements and starts the flow of information down the holding chain, and in reverse back up the holding chain to issuer CSD and then to issuer, must be maintained.

83. We should also point out that some categories of account holder at least (retail brokers, for example) will be bound by regulatory requirements (possibly

[5] The UK, where the register of legal title to securities is split between the "operator register" maintained by EUI in the CREST system for uncertificated securities and the "issuer register" maintained by the issuer or its agent for certificated securities, is a variation on this rule.

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stemming from regimes outside the EU, if that is where their clients are located) governing the quality and content of information they provide to their clients. These requirements might make it difficult for them to simply take information flowing down the chain of holdings and pass it on to their clients. This constraint should be recognised in the formulation of the Principle, as should the fact that ultimate account holders should have the freedom to determine whether or not they wish to receive certain information (there is no reason for account providers to incur costs transmitting information which the account holder has indicated he does not wish to receive).

84. Finally, we would point out that passing on information is a service to account holders for which account providers should be fairly remunerated. Account holders and providers should have the freedom to provide for this remuneration by contract, with account holders having the choice to opt out of receipt of information and the resultant cost.

Question 33: How do you see the role of market-led standardisation regarding the passing on of information? What are your views on a regulatory mechanism for streamlining standardisation procedures?

85. Current market-led standardisation initiatives for corporate actions and meeting services have moved from the standard-setting to the implementation phase; the ISO-based information flow from issuer, to issuer CSD and on down to the ultimate account holder has been described. A framework has been defined to organize compliance for each market through the Market Implementation Group and oversight committees have been created to monitor progress. Work is therefore moving forward and we see no reason to create a regulatory mechanism to work alongside it. These information flows will need to adapt over time and therefore should not be hard-coded into EU legislation. We see no need for the SLD to construct a standard information flow model.

Question 34: If you are an investor, do you think that a Principle along the lines described would make easier any cross-border exercise of rights attached to securities, provided that technical standardisation progresses simultaneously? If not, please explain why.

86. This Principle will not, in our view, make cross-border exercise of rights any easier, whether allied to technical standardisation or not, largely because it mandates a result which it is impossible to achieve. It is therefore far more likely to have the effect of forcing account providers to withdraw from providing cross-

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border services; the opposite effect from that which, we assume, the SLD intends to achieve. We say this for the following reasons.

87. Principle 17 places an obligation on the account provider of the ultimate account holder to facilitate the latter's exercise of rights, against the issuer or third party, as requested by the account holder. Our preliminary observation is that an account provider will not necessarily know that he is in the position of account provider to the ultimate account holder. For some categories of account provider (retail brokers, for example) it may be fairly obvious that they occupy this position. For other categories of account provider the position is less straightforward.

88. EUI, for example, holds international securities for the benefit of its members in a number of CSDs but has no means of knowing whether those members hold their interests in these securities on their own behalf or whether they are at the head of a long holding chain themselves. Where an account provider is in the latter position, the difficulties of making enquiries of the account providers along the holding chain in order to identify the ultimate account holder (who may not, in the UK, be a single individual or entity but a number of persons in the position of beneficiaries under a trust), and of doing so quickly enough to ensure that there is still time for that holder to exercise his rights, are likely to be insuperable in most cases.

89. Even if it were feasible, from a practical perspective, for the account provider to undertake the enquiries necessary to find out if it is in the position of provider to the ultimate holder, it may well find its account holder reluctant to divulge details of persons on whose behalf it holds securities (for reasons of legal or commercial confidentiality) and it would have no guarantee that any information or assurances it is given are in fact correct.

90. Leaving aside this preliminary point, the obligations in Principle 17 place an unfair and unreasonable burden on the account provider to the ultimate account holder, who may well be at the end of a chain of securities holdings and have no direct legal relationship with the issuer/legal holder of the securities/other third party against whom the ultimate account holder wishes to exercise his rights. In the absence of any such direct relationship, the account provider has no means by which he may fulfill the obligation in Principle 17 to facilitate the ultimate account holder's exercise of rights.

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91. With regard to the issue covered in Principle 17.1.2(a), in addition to the points made at paragraph 90, we would also say that this obligation entirely overlooks the fact that there may be obstacles in both Member States' corporate laws and the constitutions of certain issuers which mean it is not possible for the account provider to obtain the issuer's co-operation in the facilitation of the exercise of the account holder's rights, whether by the means outlined in the Principle or otherwise (in this connection, it must be recalled that in many instances issuers will be incorporated outside the EU and thus beyond the reach of its legal regime). The SLD does nothing to remove these obstacles – indeed, it cannot - which may mean that the account provider simply cannot fulfill the obligation set out in this Principle.

92. In relation to Principle 17.1.2(b), the SLD prescribes no mechanism by which the account provider of the ultimate account holder is to be enabled to compel the legal holder of the securities to recognise that he is entitled to exercise rights in relation to the securities on behalf of the ultimate account holder. Again, this obligation will, in many cases, be impossible to fulfill.

93. Principle 17.1.2(c) also fails to recognise the limitations of the position of the account provider of the ultimate account holder. As discussed at paragraph 74 above, the establishment of entitlement to rights has to start at the level of issuer CSD (or, in the case of the UK, issuer CSD plus issuer/registrar) since it is only at this level that there is visibility of the total holding. The account provider of the ultimate account holder, who may be located several tiers down from issuer CSD in the holding structure, is thus in no position to issue evidence confirming the ultimate account holder's entitlement to exercise rights or to guarantee the integrity of available rights. Similarly, the CSD at the top of the holding chain has no visibility of what ownership or other rights are passed down the chain of holdings to the ultimate account holder.

Question 35: If you are an account provider, would you tend towards the opinion that your clients can exercise the rights attached to their cross-border holdings as efficiently as their domestic holdings? What would be the technical difficulties you would face in implementing mechanisms allowing for the fulfilment of the duties outlined above? What would be the cost involved?

94. Euroclear would certainly accept that clients cannot necessarily exercise their rights in relation to their cross-border holdings as easily as they can in relation to their domestic holdings. This is largely due to the issues identified in relation to

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Question 30 and for the reasons given above in relation to Question 34 we believe that Principle 17 will not ease the position (rather the reverse).

95. The obligations for members of the Euroclear group, first in determining whether they are, in given instances, in the position of account provider to the ultimate account holder and second, in attempting to fulfill the obligations set out in Principle 17, will not merely be costly. They will, for the reasons given above, be impossible to achieve. If obligations such as those set out in principle 17 are included in the SLD, members of the Euroclear group will have to take a view as to whether it is feasible to continue providing services on a cross-border basis.

Question 36: If you are an account holder, have you encountered differing prices for the domestic and the cross-border exercise of rights attached to securities? If yes, please specify.

96. Members of the Euroclear group have certainly encountered such differing prices in their capacity of account holders, but there are clear, objective justifications for these, as outlined in relation to Question 37 below.

Question 37: If you are an account provider, do you price cross-border exercise of rights differently from domestic exercise? If yes, on what grounds are different pricing models necessary?

97. Euroclear does not approach the pricing of cross-border services differently from domestic services. However, it is necessary for Euroclear, in common with other account providers, to reflect its costs of service provision in the fees it charges to clients. These are often higher for international services because the costs inherent in providing service on a cross-border basis are much greater than the costs of providing services domestically. We note that the proposals in this area are inspired by previous legislation dealing with cross-border payments; the assumption that this is in some way analogous to cross-border transfers of securities is not correct.

98. The legal and practical environment for cross-border securities holding and dispositions is significantly more complex. This has long been recognised by the Commission in its policy papers following the publication of the first Giovannini Report in 2001 and we are surprised that the Commission appears to be re-questioning whether cross-border services are indeed more expensive to offer (and to purchase) than domestic securities services. We outline some of the areas where increased costs arise below.

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99. The OXERA report[6] which was prepared for the European Commission in July 2009 offered evidence in support of the contention that account provision and asset servicing by CSDs for cross-border securities is more costly than for domestic securities. Unfortunately these figures provide no detail at the level of the services for exercising rights but it can be assumed that these costs are included in the overall custody and safekeeping charges.

    Based on the data provided by CSDs, the comparison between costs of cross-border and domestic CSD services was as follows (Table 7.17 of the Oxera study):

	Equities		Fixed Income instruments	
Asset provision & asset servicing	Domestic	Cross-border	Domestic	Cross-border
2006 (bp)	0.16	0.38	0.20	0.29
2008 (bp)	0.15	0.36	0.18	0.39

Based on data provided by brokers, the study revealed, following comparison between costs of cross-border and domestic custody and safekeeping services charged by CSDs and custodians depending on the domicile of the security (for equities, indices – Table 7.16 of the Oxera study):

	Domicile of security	
Service provider	Domestic	Cross-border
Custodian	100	229
CSD	100	145

[6] Monitoring prices, costs and volumes of trading and post-trade services (MARKT/2007/02/G)

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100. From the Euroclear perspective, the reasons for higher cost of service provision may be divided into 3 broad categories; the costs of establishing links with cross-border CSDs and other providers, the costs of maintaining those links, and day-to-day operational costs.

Costs of establishment

101. Substantial legal and other due diligence work is necessary before establishing a link with an cross-border market, for example to determine whether the link can work legally and practically, whether it exposes the CSD to an undue level of legal risk, to build the knowledge of the local market and to create procedures relating to corporate actions and other matters that are workable in the light of local law and market practice. In certain circumstances, we might use an agent to conduct relations with the local market, but again here there are costs. Finally, of course, it is necessary to pay whatever fees are charged for admission by the local CSD.

Costs of maintaining the link

102. The due diligence described at paragraph 77 is not a one-off exercise. Member of the Euroclear group are subject to regulatory requirements to monitor and control the risks they are exposed to and therefore assessment of the legal and other risks they are exposed to by reason of their cross-border links has to be undertaken regularly.

103. Further, it is sometimes necessary, in the course of maintaining the link, to establish the eligibility for admission to Euroclear systems of certain international securities (for example, securities subject to certain transfer restrictions). A substantial amount of legal time is spent assessing whether certain types of security may be admitted. In addition the ongoing fees charged by the local CSD for participation must be paid.

Day-to-day operational costs

104. Examples of these include:

104.1. costs of dealing with corporate actions types that do not exist in the local market;

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104.2. adapting to ways of processing corporate actions that differ in the local market (e.g. different modalities for cash distributions, treatment of market claims);

104.3. liaising with multiple issuer's agents with whom we may have no established relationship, and possibly no common language;

104.4. need to adapt to different settlement windows and deadlines in the local market; and

104.5. need to adapt to different settlement model (especially for DVP links) – real-time gross settlement versus batch models, whether the settlement model allows for netting or not.

105. If account providers are not permitted to reflect these additional costs in what they charge for local services, they will either increase their charges across all their services, which would force users of domestic services to subsidise international service provision, or cease providing international services altogether, an outcome opposite to that which the SLD appears intended to achieve.

Question 38: Have you encountered difficulties in using non-EU linkages as regards the exercise of rights attached to securities? If yes, please specify. If not, please explain why.

106. The difficulties are much the same as with EU linkages (incompatible laws, need to do due diligence for example), or may actually be less acute; for EUI, for example, linking with a CSD in another common law jurisdiction may in theory be easier than linking with a CSD in an EU jurisdiction, or vice-versa.

Question 39: Admitting that non-EU account providers cannot be reached by the planned legislation, which steps could be undertaken on the side of EU account providers involved in the holding in order to improve the exercise of rights attached to securities through a holding chain involving non-EU account providers?

107. EU account providers will simply not be able to meet any obligations to ensure certain behaviour by account holders outside the EU vis-à-vis their own account holders (whether inside the EU or not), not least because these account holders will be subject to their own, wholly different legal regimes which may conflict with the regime established by the SLD. Nor, in our view,

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is it appropriate to seek to enforce EU-mandated standards on non-EU entities in this way. We would urge the adoption of the Geneva Convention as the quickest way to make progress towards a more standardised global regime for intermediated securities.

Question 40: Do you think that a general authorisation to exercise and receive rights given by the account holder to the account provider should be made subject to certain formal requirements? Please specify.

108. Again, this Principle represents an unwarranted infringement of the freedom of account providers and holders to agree levels of service and reflect these by contract. Some categories of investor are not interested in exercising the rights attached to securities and they should be free to agree levels of service with their account providers that reflect this. If there is clear evidence that account holders are being pressured to agree to levels of service that they are not happy with, this should be tackled by legislation in the area of contract law or consumer rights, rather than by setting out a blanket restriction on the service levels account providers may agree to provide.

Question 41: Should the status of account provider be subject to a specific authorisation? If not, please explain why.

Question 42: If yes, do you think that MiFID would be an appropriate instrument to cover the authorisation and supervision of account providers?

109. We agree that securities account provision is an extremely important function and we agree that it should be provided by entities regulated in a functional manner (i.e. a manner which ensures that entities providing similar functions are subject to similar requirements).

110. We do not, however, agree that MiFID is the appropriate vehicle to deliver this functional regulation. MiFID contains a number of obligations which are either irrelevant, disproportionate or ill-adapted to many account providers which do not offer investment services, or offer them only incidentally. Examples include:

110.1. rules on best execution and order handling;

110.2. conflicts of interest;

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110.3. client classification;

110.4. reconciliation obligations (not necessarily applicable to CSDs acting in their capacity of issuer CSD).

111. Further, CSDs will soon become subject to tailored prudential requirements under the CSD Regulation. Applying MiFID requirements to CSDs in addition will result in duplicated and overlapping requirements. If the SLD does extend MiFID requirements to safekeeping and administration functions, CSDs should therefore be excluded.

Question 43: Do the terms used in the Glossary facilitate the understanding of the further envisaged principles? If no, explain why.

112. We have considered the definitions in conjunction with other parties interested in this consultation, and as a result have a number of suggestions to make at this stage, as follows:

112.1. we do not consider it helpful to define "securities" by reference to MiFID investments. The approach taken in the UNIDROIT Convention (article 1(a)), which reflects a market-led, evolutionary and flexible concept of what types of "security" fall within scope, is preferable. It is capable of adapting to the dynamics of the market as participants develop new financial products that share the essential qualities of transferability and capability of being credited to a securities account;

112.2. the definition of "securities account" arguably does not include accounts maintained by EUI, ES or EFi; these entities provides a means by which their members may hold securities, but do not themselves hold securities for them. It also does not include accounts maintained by EF, whose functions consist mainly of recording in a specific account the entirety of the securities making up each issue admitted to its operations. In our view, in order to ensure that these important account providers are covered, the definition should refer simply to an account to which securities may be credited/from which they may be debited;

112.3. the same points may be made of the definition of "account provider";

112.4. the definition of "legal holder" refers to the concept of a "holder", which itself begs the question of who is considered the holder in

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relation to securities. It is a circular and self-referential definition. It would seem preferable to state that the legal holder of securities is the person who is recognised by the issuer of the securities as entitled to exercise, as against the issuer, the rights attached to the securities (whether itself or by appointment of a proxy). We would also suggest that the definition refers to "securities", rather than "financial instruments" – as securities is potentially a wider concept than financial instruments and covers other "financial assets"; and

112.5. we note that the "Definitions" section defines "CSD" and "securities settlement system" separately. It is essential that there is clarity and certainty in the use of these terms, as there may be considerable overlap between them. We would suggest that the CSD definition merely refers to the CSD Regulation.

Question 44: Would you add other definitions to this glossary?

113. We would recommend the inclusion of a definition of "rules of a securities settlement system" (as this concept is key to certain principles). The main point we would wish to see clarified is that the concept of "rules" should extend to rules constituted not only by contract, but also by the domestic law of a Member State. This is important to, for example, EUI because many of its "rules" governing issues as to reversal, authentication of instructions and protection of innocent acquirers are contained in statute (the USRs). We would recommend an approach on this issue similar to that taken in article 1(p) ("uniform rules") of the UNIDROIT Convention.

114. We would also recommend that the SLD includes clear definitions of "account maintenance" and "securities safekeeping" functions (see paragraphs 8 to 10 above). We would define these concepts as follows:

"maintains securities accounts" means to maintain, keep and enter up securities accounts and any other act in connection with the making, alteration and deletion of entries on securities accounts where:

- *the account provider may or may not in addition perform safekeeping functions in relation to the securities credited to the securities accounts; and*

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- *the securities accounts are not being maintained by the account provider on behalf of an issuer of securities under arrangements made between the account provider and the issuer.*

"securities safekeeping" means the safekeeping and administering of securities for the account of clients.

Contacts

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