COE ソフトロー研究資料 3

EU-Legislation on securities settlement and the UNIDROIT preliminary draft Convention

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1st Part: The need for harmonisation of private law issues with respect to transfer and holding of securities through intermediaries

During the last fifty years, the practice of holding and disposition of investment securities has changed considerably. The basic rules on the legal nature of securities, the rights of issuers and holders and the manner in which securities can be transferred and provided as collateral were formulated in the days when securities were transferred individually by physical delivery and when there was a direct relationship between issuers and holders. However, this direct, two-party model no longer applies to the great majority of securities transferred through modern financial markets. Instead, considerations of speed, efficiency and economy of settlement have led to the evolution of a sophisticated system of intermediaries, through which securities can be held and transferred in book entry form, generally by computerised means.

In several jurisdictions, the legal framework which underlies this modern system of holding through intermediaries in many countries has not been updated with regard to these changes. The laws often use traditional tools and concepts adapted from other contexts. To take an example, the key concept of custody generally builds on traditional rules defining the rights and obligations that arise where the owner of a physical object deposits it with another person for safe keeping. Traditional key concepts were generally comparable in most jurisdictions, in particular as regards the element that the holder of an investment security was generally regarded as full proprietor. However, the considerable amendments to these concepts that were necessary to adapt to modern market practices (in particular the holding of investment securities through chains of intermediaries like banks or brokers) were made in an uncoordinated manner amongst jurisdictions. Today, as a result, the law governing the holding and transfer of securities differs considerably between countries and different solutions to this modern form of holding and through intermediaries are applied, the basic models of which are the property-, the trust- and the entitlement concept. Because of this “patchwork” of concepts, the legal risk in the area of holding and disposition of investment securities, in particular with respect to cross-border situations, is particularly high.

At a first glance, this situation appears to be a pure question of conflict-of-laws. Naturally, parties need to be sure which country’s law governs the various legal issues relevant to their rights. As traditional conflict-of-laws rules do not always give a clear answer when applied to modern holding and transfer patterns, a harmonised conflict-of-laws rule was introduced on the European level (Article 9 of the Settlement Finality Directive and Article 9 of the Collateral Directive) and proposed on a global level (Hague Convention on indirectly held securities).

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[*] This text is the short summary of a lecture given on 28 February 2005 at Tokyo University. It only reflects the personal opinion of its author. Further information on UNIDROIT and its work programme is available at www.unidroit.org. Further information on EU legislation in this field is available at www.europa.eu.int/comm/internal_market/financial-markets/index_en.htm.

However, 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 holding and transfer of investment securities do not properly interconnect and give rise to inefficiency or legal uncertainty. International instruments on harmonisation of substantive law are the appropriate solution to these remaining deficiencies.

2nd Part: Basic features of substantive law harmonisation

Against the background of the aforementioned situation, the purpose of both European legislation and the UNIDROIT preliminary draft Convention is two-fold: first, the internal reliability and soundness of each national system is to be enhanced, and, second, the cross-border compatibility of private law aspects of holding and transfer of investment securities needs to be assured.

In the EU, a single financial market is under construction since 1973. There are, in the field of legal certainty with respect to holding and transfer of investment securities, already two directives (that needed to be implemented by each of the 25 EU member States) in place: Directive 98/26 on *Settlement finality in payment and securities settlement systems* and, Directive 2002/47 on *Financial collateral arrangements*. Recently, the EU Commission brought the *Legal Certainty Project* underway.

The Settlement Finality Directive (1998) addresses legal risk in securities settlement systems, i.e. it provides for a clear solution regarding the rights and obligations of participants in such a system in case of insolvency of a participant, where still financial positions are open. The basic feature is the so-called *finality* aspect, which *describes* the moment in time when obligations of payment or settlement are discharged; that is, when the transfer is irrevocable and unconditional. This is particularly important in cross-border situations, where according to the applicable insolvency rules transactions may be reversed, even retroactively. As to the personal scope: a “system” consists of three or more participants that transfer securities and related payments under standardised arrangements for the execution of such orders.

The Financial Collateral Directive (2002) aims to remove major impediments to the cross border use of securities collateral. Both types of collateral arrangements are covered: first, arrangements under which ownership remains with the collateral provider and arrangements that entail a transfer of title to the collateral taker. The directive abolishes formalities regarding creation, perfection and registration of collateral interests and provides for simplified procedure for enforcement in case the underlying obligation is not paid, notable by sale or appropriation of the collateral securities by the collateral taker and subsequent set-off against the underlying financial obligation. Furthermore, certain widely used techniques of the market (top up and substitution of collateral; closeout netting and right of use) are codified. This instrument generally applies to public institutions and supervised financial service providers but not to individuals.

As both directives only cover isolated, though most important, aspects of the law relating to holding and transfer of investment securities, the EU in January 2005 embarked on a more comprehensive initiative, entitled the Legal Certainty Project. A group of independent experts has been created, whose aim is to submit a proposal for EU legislation regarding the following issues: (a) exact definition of investor’s ownership rights; (b) protection from intermediary’s

insolvency; (c) the central position of book entries; (d) prevention from upper-tier-attachment; (e) simple and clear priority rules; (f) avoidance of shortfall of securities; (g) corporate action processing. As this process is about to start, it is not clear yet whether the outcome will be soft law, for example a legislative guide, or hard law, i.e. a directive or a regulation under the EU treaty.

Against the background of the – to date – fragmented legal framework of the EU and the need for a global instrument capable of eliminating legal risk in cross border holding and transactions of investment securities, in 2002, UNIDROIT commenced work on an international treaty (Convention) regarding substantive law governing securities held with an intermediary. A 14-member strong expert group drawn from all over the world worked on a preliminary draft for approximately two years. The draft firstly covers the essential features to minimise legal and systemic risk: (a) clear and simple rules for acquisition and disposal of as well as providing collateral over securities; (b) the effectiveness of such transaction; (c) protection of the system against disruptions; (d) protection of the account holder against intermediary risk; (d) integrity of the issue. Secondly, during the work it became clear, that the following issues needed to be treated, though not directly themselves related to legal and systemic risk in a cross boarder context: (e) the reception of dividends and the exercise of corporate rights (clarification only); (f) the possibility to set off against the issuer of bonds. Thirdly, on the basis of economic, particularly efficiency considerations, the working group included provisions relating to: (g) net settlement; (h) right of use, top up and substitution of collateral, and (i) and realisation of collateral.

In the further process of the recent EU Legal Certainty Project and the negotiations of the UNIDROIT draft Convention, there will be a particular need for co-operation and co-ordination. Both instruments should be inter-compatible. Otherwise, countries will fail to provide for a really global solution to private law issues regarding cross border holding and transfer of investment securities that are held with intermediaries.