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Directorate General Internal Market and Services
European Commission
C107 5/32
B-1049 Brussels
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markt-consultation-sld@ec.europa.eu

Dear Sirs

Consultation Paper: Legislation on Legal Certainty for Securities Holding and Dispositions, 5 November 2010 (G2 MET/OT/acg D(2010) 768690)

The remit of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets that might give rise to material risks and to consider how such issues should be addressed.

This letter sets out the FMLC's response to the European Commission's consultation paper entitled "Legislation on Legal Certainty for Securities Holding and Disposition", dated 5 November 2010 (the "Consultation Paper"), which seeks comments on a set of principles to underpin a proposed European Securities Law Directive ("SLD").

The FMLC considers that the most important requirement for any SLD that may be enacted by the European Union ("EU") is that it be consistent with and complementary to the legal framework established by the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the "Geneva Securities Convention" or the "Convention"). Although the EU is yet to adopt the Convention, the FMLC considers that it will be important for any regulatory regime established under an SLD to be able to operate efficiently and effectively as part of the globally harmonised system that is envisaged by the Geneva Securities Convention. If the Commission considers that an SLD is required in addition to the Convention (for example, in order to harmonise certain matters that are left by the Geneva Securities Convention to non-Convention law), the FMLC considers that compatibility between the two instruments will, *inter alia*, be important to promote legal certainty in this area both within Member States and in relation to cross-border transactions and relationships within the EU and with non-EU entities, thereby supporting the operation of the European securities markets more generally.

Further, the FMLC considers that the likely importance of the Geneva Securities Convention to the international securities markets in the future means that it will be important for any SLD to incorporate an inbuilt structure that provides for the monitoring and review of national implementation of the SLD

on an ongoing basis. In order to keep the two regimes aligned on an ongoing basis, this exercise would need to include monitoring the operation of the Geneva Securities Convention regime by non-EU countries so that any inconsistencies between the parallel regimes that arise in practice can be identified and addressed.

An area of concern for the FMLC is the proposal in the Consultation Paper to define "securities" as financial instruments as listed in Annex I, Section C of Directive 2004/39/EC Markets in Financial Instruments ("MiFID").[1] The list of financial instruments in MiFID includes, *inter alia*, derivative contracts. By referencing MiFID in this way, the Consultation Paper abandons the restrictive qualifier in the definition of "securities" in Article 1(a) of the Geneva Securities Convention, which states that:

> "securities" means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention. (Emphasis added.)

The phrase, "in accordance with the provisions of this Convention", indicates the intention of UNIDROIT to exclude derivatives and other instruments not conventionally regarded as securities from the scope of intermediated securities legislation. The FMLC is of the view that a definition of "securities" in the SLD that mirrors or, at least, includes a similar restrictive qualifier as the definition provided by the Convention would effect greater harmonisation of securities law in the EU and promote legal certainty. Alternatively and as a minimum, the definition should expressly exclude derivatives. If thought desirable, a further provision might require the Commission to make a recommendation at a later date as to whether or not derivatives should be included. (If the Commission's proposals for the centralised clearing of over-the-counter derivatives result in a market wide transfer of derivative settlement to settlement systems, it may be thought appropriate to include derivatives as financial instruments within the purview of the SLD.)

The Consultation Paper has addressed the concerns of the Giovannini Group set out in their first report on clearing and settlement in November 2001,[2] by giving extensive consideration to account holders' interests in securities in cross-border transactions.[3] However, the Paper appears not to appreciate fully the impact of the Commission's proposals on account providers.[4] This is evident when examining the interaction of Principles 1 and 18 as set out in the Consultation Paper. Principle 18 proposes that services provided to account holders for the cross-border holding of securities should be charged at the same rate as for the domestic holding of securities. This would prevent account holders from recovering compensation through (even objectively justifiable) service charges for the costs and risk of providing services for securities held in a foreign central securities depositary.[5] Simultaneously, Principle 1 proposes that "*all*" account providers should be regulated by MiFID, which would increase the regulatory and compliance burdens (and associated costs) on account providers. The combined effect of Principles 1 and 18 is therefore, at one end, to increase costs for account providers and, at the other end, to reduce the means available to recover those costs. The securities industry therefore would become a less viable arena to conduct business in. Whilst it is not within the remit of the FMLC to comment on policy decisions (and rules on fees fall within policy choices), the FMLC believes that the fact that the impact on account providers appears to have been overlooked could cause unforeseen systemic risk in the financial markets. The FMLC, therefore, does not go so far as to urge the Commission to follow a different approach, but does

1 European Commission: Directorate General Internal Market and Services, 'Legislation on Legal Certainty of Securities Holding and Dispositions' (2010), question 43 and section 22.

2 The Giovannini Group, 'Cross-Border Clearing and Settlement Arrangements in the European Union' (2001) <http://ec.europa.eu/ internal_market/.../first_giovannini_report_en.pdf >. See section 5 on the barriers to efficient cross-border clearing and settlement.

3 Uses of the terms "account holder", "ultimate account holder" and "account provider" in this letter are meant as defined in section 22 of the Consultation Paper.

4 DG MARKT, 'Consultation Paper', questions 1 and 36.

5 Investment firms commonly reflect in their price tariffs the differing levels of intermediation, cost structures and levies imposed in other Member States.

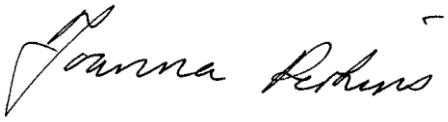
advise the Commission to undertake further consideration of the impact of Principle 18 on account providers.

The broad liability placed on account providers by Principle 4 of the Consultation Paper may also import systemic risk into the financial markets. Principle 4 recommends that an account provider should compensate an account holder for losses suffered and promptly provide additional comparable securities if the account provider makes a credit entry which does not correspond with the actual number of securities held.[6] It further provides that an account provider may enter into a contractual agreement with an account holder to share the costs associated with providing additional securities only in limited circumstances involving cross-border holdings with third countries—notably cases regulated under Article 17(3) of Directive 2006/73/EC implementing MiFID.

Although Principle 4 does not purport to establish a new civil liability regime as such, in reality it will operate to impose liability for loss on the account provider. As the proposed test leaves little or no room for common defences to liability such as *force majeure* or an exercise of reasonable care by the account provider, Principle 4 effectively imposes a new standard of care which is both (i) unfamiliar; and (ii) analogous to strict liability. Where the securities in question are in the control of a sub-custodian, Principle 4 requires an account provider in effect to underwrite the solvency and operational efficiency of that sub-custodian. This would make it costly for account providers to insure their liabilities or perhaps make the liabilities practically uninsurable. The effect of the proposals may, therefore, be to create a degree of systemic financial stability risk. The increased burden on account providers may create a barrier for any newcomers looking to enter securities markets and thus raises concerns from a competition perspective. Again, although it is not within the FMLC's remit to comment on policy choices, the FMLC believes that a thorough impact analysis that considers the effect of the proposals on account providers as well as account holders would be beneficial.

I would be happy to discuss any of the above comments[7] with you further. Please do not hesitate to contact me if you would like to do so.

Yours sincerely



Joanna Perkins
FMLC Director

6 DG MARKT, 'Consultation Paper', question 10.

7 The FMLC is grateful to Guy Morton, Martin Thomas, Habib Motani, John Ahern, Pauline Ashall, Dorothy Livingston and Geoffrey Yeowart for their assistance with preparing this letter.