7 Articles 34, 35 and 46 of MiFID

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7.1 CLEARING AND SECURITIES' SETTLEMENT SYSTEMS IN MiFID

7.1.1 The importance of 'post-trading'

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments ('MiFID'), amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, took an important step for the promotion of an integrated and efficient European capital market, harmonising issues of operation of regulated markets and Multilateral Trading Facilities[1] (MTF) at a European level. This has been achieved mainly by the expansion – through MiFID – of the list of core investment services and activities, with the addition of the Operation of Multilateral Trading Facilities, as well as the detailed regulating under Title III of the Regulated Markets as to issues, among other, of authorisation, supervision and, in general, prudent regulation, taking into consideration the expected positive impact of the Lamfalussy process for the substantial harmonisation in depth of the European securities markets.[2]

Safe and efficient finalisation of the transactions on financial instruments being admitted to trading in regulated markets constitutes the necessary supplement of the whole section 'markets in financial instruments' and is indispensable for the proper functioning of the securities markets,[3] even if most public attention is captured by trading.[4] Trading of financial instruments without satisfactory clearing and settlement of the relevant transactions has no meaning or substance.[5] The securities market cannot function efficiently if efficient post-trading services are not available. Economic studies have shown the importance of 'post-trading'[6] for the integration of EU financial markets and of the economic impact of a lowering of post-trading costs on EU Gross Domestic Product.[7] Cross border securities transactions are exposed to higher costs and higher risk for investors but also for financial actors.[8] National efficiently operating domestically post-trading systems suffer in various aspects when required to interact and to work across borders. They combine and communicate less efficiently and less safely. This situation negatively influences the issuers of securities, the investment firms and the regulated markets and MTFs as well as the investors, regarding their behaviour and entrepreneurial/investment decisions, producing fragmentation of the internal market and distortion in free competition.[9]

Cross-border free movement of securities in the EU not only requires free access of the investment firms to regulated markets for trading purposes, but is also closely connected with the capability of the investment firms to access the central counterparties, clearing and settlements systems (SSSs) of all the Member States. A SSS can provide arrangements to its participants by establishing direct links with other systems or relayed links where a

third Central Securities Depository (CSD) is used as an intermediary.[10] However, there are very often no common or even consistent structures, standards or operational rules concerning these links. The financial services infrastructure thus, comes out as a vital factor towards the smooth functioning of the securities markets' system within the EU. Legal certainty and economic efficiency of SSSs in the European securities market are, as such, critical points for the completion of the European financial market. Parties dealing in securities need to be sure about the good and effective finalisation of the transactions concluded over securities in the European markets. Taking into consideration the status of the Member States' securities markets, this issue is of practical significance mainly in cross-border transactions, where linked transfers of securities take place through different intermediaries and settlement systems, operating under different laws.[11] Otherwise, legal uncertainty and systemic risk could arise, severely impairing the efficiency of the single European market.[12]

The importance of Articles 34, 35 and 46 of the MiFID, dealing with issues of SSSs in relation to the European markets in financial instruments is, therefore, evident. It should be noted that Articles 34 and 35 apply not only to investment firms, but also to credit institutions providing investment services, according to Article 1, para 2 of MiFID. Hence, any reference to investment firms in the text hereinafter shall include also credit institutions.

1 According to Article 3, para 1(15) of MiFID, an MTF means 'a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II'.
2 *See, inter alia*, M Blair and G Walker (ed), *Financial Services Law* (Oxford University Press, 2006); E Ferran, *Building an EU Securities Market*, (Cambridge University Press, Cambridge, 2004); G Ferrarini and F Recine, 'The MiFID and internalization' in G Ferrarini and E Wymeersch (eds), *Investor Protection in Europe, Corporate Law Making, the MiFID and beyond* (Oxford University Press, Oxford, 2006), pp 235-296; M Tison, *Financial Market Integration in the Post-FSAP Era*, Financial Law Institute Working Paper No 9, 2006, p 10 et seq; Avgouleas, 'A Critical Evaluation of the new EC Financial-Market Regulation: Peaks, Troughs and the Road Ahead', *The Transnational Lawyer* vol 18/2005, p 179 et seq.
3 Commission Communication of 28 April 2004 *Clearing and Settlement in the European Union – The Way Forward*, Brussels, COM(2004) 312, p 3.
4 European Commission's (DG XV) *Draft Working Document on Post Trading*, at http://ec.europa.eu/internal_market/financial-markets/docs/clearing/draft/draft_en.pdf.
5 Post-trading has been characterised metaphorically as the 'plumbing' of the securities market. European Commission's (DG XV) *Draft Working Document on Post Trading*, p 2; European Parliament, *Report on Clearing and settlement in the European Union* (2004/2185(INI)), Committee on Economic and Monetary Affairs (Rapporteur: Depute Piia-Noora Kauppi), p 10.
6 According to the European Commission's (DG XV) *Draft Working Document on Post Trading*, *supra* fn 4, p 2, post trading has been described as a chain of actions designed safely to transfer ownership of a security from the seller to the buyer in return for payment.
7 European Commission's *Draft Working Document on Post Trading, supra* fn 4, Annex II; Niels Schulze and Dirk Baur, European Commission, DG JRC, *Economic Impact Study on Clearing and Settlement*, May 2006, p 14 et seq.
8 European Commission's *Draft Working Document on Post Trading*, *supra* fn 4, p 2.
9 *See* European Commission, Competition DG, Working document of 24 May 2006 *Competition in EU securities trading and post-trading*, Issues Paper.
10 CESR/ECB Standards, Standard 19 and Explanatory memorandum no 197, *infra* **7.2.3**, fn **1**, p 79.
11 Cf Recommendation 19 CPSS/IOSO, providing that 'CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements', European Commission's *Draft Working Document on Post-Trading*, *see supra* fn **4**, p 25 and Klaus M Loeber, 'The Developing EU Legal Framework for Clearing and Settlement of Financial Instruments' *European Central Bank Legal Working Paper Series*, No I / February 2006, p 48.
12 Loeber, ibid p 4 and p 54.

7.1.2 Central counterparty, clearing and settlement systems

Article 34 as well as Articles 35 and 46 of MiFID are structured on the basis of the terms 'central counterparty', 'clearing system' and 'settlement system', the definition of such terms not being included in MiFID.

If one refers to other texts of secondary EU law, it will be ascertained that in Article 2 of the Settlement Finality Directive 98/26/EC ('SFD') the definition of 'central counterparty' is given as, 'an entity which is interposed between the institutions in a system and which acts as the exclusive counterparty of these institutions with regard to their transfer orders.' In the same article of the SFD the following terms have also been defined:

- 'system' – 'a formal arrangement between three or more participants, without counting a possible settlement agent, a possible central counterparty, a possible clearing house

or a possible indirect participant, with common rules and standardised arrangements for the execution of transfer orders between the participants';

- 'settlement agent' – 'an entity providing to institutions and/or a central counterparty participating in systems, settlement accounts through which transfer orders within such systems are settled and, as the case may be, extending credit to those institutions and/or central counterparties for settlement purposes'; and
- 'clearing house' – 'an entity responsible for the calculation of the net positions of institutions, a possible central counterparty and/or a possible settlement agent'.

Further, according to the definition given by the European Central Securities Depositories Association (ECSDA)[1], a Security Settlement System is, 'a system which permits the holding and transfer of securities, either free of payment (FOP) or against payment (DvP). It comprises all the institutional arrangements required for the settlement (and sometimes the clearing) of securities trades and the safekeeping of securities. Settlement of securities occurs on securities deposit accounts held with the CSD, International CSD or institution in charge of operating the system.'

The differentiation in these terms is basically a result of the different philosophies of the texts in which they are being introduced. As far as MiFID is concerned, a functional wide approach for the definition of these terms is the most convenient due to the lack of regulation in the EU law on clearing and settlement systems in the framework of the markets in financial instruments. The definition must cover all systems operating in the European Union and being used for the finalisation of transactions on financial instruments which are admitted to trading in regulated markets and/or MTFs, as well as for the preparation of such procedure, eg, through verification/comparison and reconciliation of transaction details and the transfer orders following such transactions, to ensure that there is agreement on these details and, thus, clearing and settlement can safely follow.[2]

Such a wide definition serves in the best manner the post-trading perspective of the Articles under review. For that purpose, the definitions provided in *Draft Working Document on Post-Trading* of the Internal Market DG of the European Commission seem to be most appropriate for this target.[3] Thus, Central Counterparty (CCP) should be understood to be any entity which interposes itself, directly or indirectly, between the counterparties involved in a transaction in financial instruments in order to assume their rights and obligations, acting as the direct or indirect buyer to every seller and as the direct or indirect seller to every buyer.[4] As such, the CCP undertakes the counterparty credit risk. A clearing system should be understood to be the system (including any kind of arrangements) in which 'the process of establishing settlement positions, including the calculation of net positions, and the process of checking that securities, cash or both are available'. Finally, a settlement system should be understood to be the activity 'of crediting and debiting the transferee's and the transferor's accounts respectively, with the aim of completing a transaction in securities'. The notion of SSSs includes, in that sense, mostly CSDs; not, however, in the case whre the latter are only acting as registrars, in relation to the issuer, and do not settle transactions.

1 The ECSDA's Response to the Giovannini Report Barrier 3, Corporate Actions – Part 2 Market Claims, July 2006, p 25.
2 Loeber, supra, p 6.
3 Central counterparty clearing: The process by which a third party interposes itself, directly or indirectly, between the transaction counterparties in order to assume their rights and obligations, acting as the direct or indirect buyer to every seller and the direct or indirect seller to every buyer. Book entry settlement: the act of crediting and debiting the transferee's and transferor's accounts respectively, with the aim of completing a transaction in securities.
4 Loeber, supra, p 6.

7.2 RULES OF MIFID HANDLING SECURITIES' SETTLEMENT SYSTEMS

7.2.1 Content of Article 34 and its systematic placement in MiFID

Article 34 systematically follows up Article 33 of MiFID. The right of membership or access of investment firms to regulated markets of all Member States (Article 33, para 1 of MiFID)

would be without content if it was not accompanied by the right of the investment firms themselves to participate in the central counterparty, clearing and settlement systems, through which the transactions in financial instruments in this regulated market are finalised, eg, in a case of sale, ownership of the securities is transferred from the seller to the buyer in return for payment.

The main content of such a rule is the establishment of a right of EU investment firms to have access to the facilities of each SSS operating in the Member States of the European Union.

7.2.2 Paragraph 1 of Article 34

7.2.2.1 *The principle*

Article 34(1) includes the obligation of the central counterparty, clearing and settlement systems, corresponding to the right of the investment firms, to ensure access to the investment firms of all Member States of the EU 'for the purposes of finalising or arranging the finalisation' of transactions in financial instruments. The second subparagraph of article 34(1), actually obliges the Member States, the law of which governs the central counterparties, clearing and settlement systems, to impose on the latter the obligation to accept as counterparties or their members the investment firms of each Member State,[1] so long as such participation is required for the finalisation of a transaction in financial instruments.

The Directive is correctly using the neutral term 'finalisation' when referring to the last phase of transactions, which have as their object financial instruments. On the basis of terms of the civil law jurisdictions, it is the disposal part of the transaction which has as its object financial instruments. The contractual legal act, which is constituted with the conclusion of the transaction (usually sale) over financial instruments, is consummated with the fulfilment of the obligations of the contracting parties. In the simple case eg, of the sale of securities, the contractual transaction is traditionally followed by the transfer of ownership over securities in parallel to the payment of the price. The disposal result of the real property legal act, ie, the perfection of the interests acquired by the parties through the sale transaction, with effects *erga omnes*, characterised as settlement of the transaction, includes the fulfilment of obligations of the parties concerning the payment of money and the transfer of ownership of securities and, respectively, the satisfaction of corresponding claims for collection of the money and the acquisition of the securities.[2] MiFID, rightly, does not touch upon such matters. The procedure of settlement is dependant, however, upon the type of financial instruments, their form, in particular when they are the object of a transaction,[3] as well as the rules governing the regulated market or the MTF as to the clearing of the transactions executed therein.[4]

1 The fact that the provision is referring to investment firms from other Member States is due to its legal technicality and also to its legal-political goal, which is the facilitation of cross-border relationships.
2 Cf 'The FMLC Report on Property Interests in Indirectly Held Investment Securities: an Analysis of the Need for and Nature of Legislation in the United Kingdom', in *Uniform Law Review*, 2005-1/2, p 348; Loeber, *supra*, p 6.
3 See *infra* at **7.3.2.1**.
4 See *infra* at **7.3**.

7.2.2.2 *Non discriminatory treatment*

Despite the fact, however, that Article 34(1) introduces the right of investment firms to participate in SSSs, the particular provision is, in substance, particularly impecunious as to its regulating field. The first indent of the second subparagraph of Article 34(1), which sets the limits as to the ambit of the obligation of the central counterparties, clearing and settlement systems, lays the true dimensions of the provision, at the level of the non-discretionary treatment and the transparent and objective criteria. In other words, it does not specify the criteria of access of the investment firms to the SSSs' facilities; it only prohibits the SSSs from introducing different criteria for the access to those facilities for investment firms independently of their establishment in the country, the law of which governs the operation of the SSS, from those criteria which are in force in terms of local participants.

Second indent of second subparagraph of para 1 adds that it is not permitted to limit the above mentioned right of the investment firms regarding the 'use of those facilities' only to transactions over financial instruments concluded in regulated markets and MTFs which operate in the territory of the Member States, the jurisdiction of which governs the central counterparty, clearing and settlement system. Thus, the right of access is provided also for transactions concluded in regulated markets and MTFs operating in the territory of Member States other than the Member State, the jurisdiction of which governs the SSS, as well as for transactions which are executed by investment firms outside regulated markets and MTFs, eg, systematic internalisers, independent of the place of execution of those transactions.

Article 34(1), thus, requires the clearing and settlement systems of the EU to be open and to offer their facilities for the finalisation of transactions on financial instruments –mostly held with them – to every investment firm of each Member State, independently of:

- whether that investment firm is established or not in the country, in which the settlement system is located; and
- whether the investment firm concludes transactions to be settled in a regulated market or an MTF located in the territory of the country, in which the settlement system is located, or in another regulated market or MTF or even over the counter, eg, through the investment firm acting as systematic internaliser.

7.2.3 Article 34(2): the principle and its limits

Analogous is the perception of Article 34(2). Even though para 1 establishes the right of investment firms to have access to the SSSs which are established and operating in the EU for the purposes of finalising or arranging the finalisation of the transactions in financial instruments that they conclude, paragraph 2, supplementing the first one, concentrates on the regulated markets in which those financial instruments are admitted and the relevant transactions are executed. The particular provision, aiming at the achievement of the same uniform goal as the whole section of the provisions under discussion, deals with the issue from another perspective, in comparison to that of paragraph 1, supplementing the latter: taking into consideration that Title III of the MiFID and, especially, Article 36 contain prudential rules regarding the regulated markets as well as public law governing the trading conducted therein shall be that of the home Member State of the regulated market, Article 34(2) imposes that the home Member States of the regulated markets oblige such markets to conform with the principles set in this paragraph concerning the designation by their members/participants of the SSS, in which transactions will be finalised. Thus, the law of the Member State governing the operation of a regulated market must provide that the latter grant to their members or participants the right to designate the SSS in which the transactions on financial instruments that they conclude would be settled. Indeed, any limitations imposed by the regulated markets to their members or participants as to the choice of the system for the settlement of transactions in financial instruments undertaken on those regulated markets, would substantially annul the rule of the first paragraph.

From another point of view, the provision of paragraph 2 is more particular than and supplementary to paragraph 1. It ensures, in other words, that all members and participants of a regulated market have the right to be exercised towards the latter, where applicable, to designate the system for the settlement of transactions in financial instruments undertaken in that regulated market. To the extent, however, that the provision of Article 34(2) refers to members and participants of a regulated market, it is, first of all, wider than that of paragraph 1 referring to investment firms since Article 42(3) of MiFID defines that the circle of possible members and participants of a regulated market, apart from the investment firms and credit institutions, may also include other persons who fulfil the conditions of that provision, as long as the regulated market so resolves.

It is understood that the access right of the members of a regulated market in the settlement system of their choice should be recognised independently of their establishment at that place of operation of the regulated market. Hence, such a right is also effective in terms of remote members.

However, even though paragraph 2 initially introduces the rule that the regulated markets should offer all their members or participants the right to designate the settlement system, the existing technical and infrastructure conditions as to the settlement of transactions concluded in a regulated market would, in principle, render extremely complicated the option to settle the transactions concluded in a regulated market in different SSSs. For numerous reasons it would be rather difficult, if not impossible, to break down the entirety of the settlement in the same SSS of all transactions concluded in a regulated market. For reasons such as these, a significant limitation of such entitlement to be granted by the regulated markets follows thereafter: in order for the particular right of the members of participants of the regulated markets to designate the settlement system that they prefer to operate and be realised, there must exist between such settlement system and the regulated market such links and arrangements 'as are necessary to ensure the efficient and economic settlement of the transaction in question'.

Further, under Article 34(2)(b) the consenting opinion of the 'competent authority responsible for the supervision of the regulated market that technical conditions for settlement of transactions concluded on the regulated market through a settlement system other than that designated by the regulated market are such as to allow the smooth and orderly functioning of financial markets' is required.

Those conditions are, on the one hand, objective and reasonable, but, on the other, the provisions of article 34(2) use vague legal definitions/general clauses and technical terms. Those terms shall be determined and specified by the jurisdiction of each Member State. Their content must be determined through a complicated procedure, on the basis of facts which the legal science shall seek in other scientific fields, ie, through an interdisciplinary procedure. Further, the role of the supervisory authorities and industry practice in that procedure should not be ignored. Based on the above, an element of legal uncertainty and variability at the application of those provisions in the Member States is inevitable.

That uncertainty is, of course, limited by the existence of standards and recommendations for securities clearing and settlement which have been drafted by international organisations, such as the recent draft Report entitled *Standards for securities clearing and settlement in the European Union,*[1] prepared by the joint Working Group of Committee of European Securities Regulators (CESR)[2] and the European Central Bank (ECB), and previously the CPSS-IOSCO Recommendations.[3] The relevant MiFID provisions took into consideration, and conform to, the mentioned standards. For example, Article 34(2)(b) is in accordance with Standard 18 of the draft CESR and ECB Standards,[4] which requires that, 'entities providing securities clearing and settlements services should be subject to, as a minimum, transparent, consistent and effective regulation and supervision. Securities clearing and settlement systems/arrangements should be subject to, as a minimum, transparent consistent and effective central bank oversight.'

Furthermore, in these draft Standards, guidelines can be traced for the specification of vague legal terms found not only in Article 34(2) but also in Articles 35 and 46, as will be analysed below. According to these standards/recommendations, only risk considerations are acceptable as criteria for the access to the SSS.[5] Furthermore, 'CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.'[6]

However, the formal adoption of the draft ESCB-CESR Standards is still pending. Thus, notwithstanding their merit, the said draft standards do not have any effect in law, do not constitute legally binding texts nor do they exhaust all issues that may arise in the case of a request by an investment firm to have access to the facilities of a SSS. In any case the legal basis of such Standards is still under consideration. The latter issue has been emphasised by the European Parliament.

It remains that the provision of the necessary regulatory and supervisory framework by EU Member States' national supervisory and regulatory authorities, through a set of coherent measures, is still necessary for the integration of the post-trading market, in order to ensure free access to the SSSs and proper mitigation of risks.

Going some way towards achieving the scope of Article 34(2) is the European Code of Conduct on Clearing and Settlement, which initially covers cash entities.[7] The Code has

been drafted by the Federation of European Securities Exchanges (FESE), the European Association of Central Counterparty Clearing Houses (EACH) and the ECSDA in their effort to eliminate access barriers to SSSs and for the purposes of achieving greater efficiency and further integration of European capital markets. The Code was delivered to EU Commissioner Charlie McCreevy on 7 November 2006.

The main objective of the Code of Conduct has been 'to establish a strong European capital market and to allow investors the choice to trade any European security – whether it is a domestic or a foreign security – within a consistent, coherent and efficient European framework', and its ultimate aim is 'to offer market participants the freedom to choose their preferred provider of services separately at each layer of the transaction chain (trading, clearing and settlement) and to make the concept of 'cross-border' redundant for transactions between EU Member States.'[8]

In that framework, the principles related to the areas mentioned below have been set, the implementation of which assists in the elimination of Barriers 2 and 10 identified by the Giovannini Group Report:[9]

- price transparency, for the purposes of assisting investors in the comprehension and comparison of prices versus services;[10]
- standard unilateral access between organisations and interoperability, for the purposes of facilitating the interconnection of the organisations and increasing freedom of choice of market participants; and
- service unbundling and accounting separation in order to enhance competition, increase investors' choice and provide investors with information on related services.

The set of principles concerning the first and second areas have already been implemented whereas the third one on service unbundling and accounting separation is expected to have been implemented by 1 January 2008, this being the scheduled date for the completion of the implementation of the European Code of Conduct on Clearing and Settlement by the participating organisations.[11]

With regards to the second set of principles on access and interoperability, the Access and Interoperability Guideline was issued on 28 June 2007 by the same bodies which drafted the above-mentioned Code of Conduct.[12] The general principles introduced in this Guideline are the following:

- Operational Efficiency Principle – the existing operational efficiency of financial markets should not be significantly weakened by the development of new links;
- Reciprocity Principle – where an Organisation is requesting a link with another Organisation, the latter has the right to refuse such link where the requesting Organisation is not facilitating a respective request for a link with the latter;
- Receiving Party Principle – the Organisation requesting a link should comply with legal, fiscal and regulatory arrangements applicable to the Organisation receiving the link request;
- Non-extension Principle – the Organisation receiving the link request is not obliged to extend the scope of the product; and
- Non-discrimination Principle – all relationships between linked Organisations should be maintained on an equal treatment basis.

Despite its indisputable merit, it must be noted that the implementation and application of the particular Code is in no case mandatory but rather a 'voluntary self-commitment by the undersigning Organisations.'[13]

Further, even if such principles were applied by all SSSs operating in the European Union, there still remain identified legal barriers relating to the nature of securities held with intermediaries and their holding pattern.[14]

In consideration of the need for the market's infrastructure for further integration, the European Central Bank has resolved to move along with the creation of a single settlement system for transactions executed in the euro area, the so called TARGET2-Securities (T2S) to be operated fully by the Eurosystem.[15] It is believed that the establishment of T2S will assist in the reduction of settlement costs in the euro area, increasing the sector's efficiency.[16] Currently, the particular project is at a consultation process phase regarding the nature,

scope and general principles of T2S, launched in May 2007 for the purposes of drafting T2S users' requirements.

In any case, it must be stressed that Article 34 does not oblige the Member States to introduce a regime for the licensing and supervision of the central counterparty, clearing and settlement systems. Nonetheless, through the supervisory authority, which is responsible for the supervision of the regulated markets, the existence of the supervision of the central counterparty, clearing and settlement systems is indirectly introduced as a criterion enhancing the claim of the members and participants of regulated markets to designate such a system.

The analysis that has been included above shows that there are still many issues which may arise at the specification process of the provision of Article 34(2) as to the legal soundness regarding the criteria for access to SSSs. Such criteria are also closely linked with the interoperability between SSSs themselves as well as between SSSs and regulated markets and MTFs.

1 CESR/European Central Bank, Draft Standards for Securities Clearing and Settlement in the European Union, September 2004.
2 For more info on CESR, see http://www.cesr-eu.org/.
3 Committee on Payment and Settlement Systems and Technical Comm[illegible]f the Ir[illegible]rnational Organisation of Securities Commission, Recommendations for Securities Settlement Systems, November 2001.
4 Supra fn **1**, p 14
5 CESR/ECB, Standard 14, supra fn **1**, pp 3-6, Loeber supra, p 26.
6 CESR/ECB, Standard 14, supra fn **1**, p13.
7 For the full text of the Code, see http://ec.europa.eu/internal_market/financial-markets/docs/code/code_en.pdf and http://www.fese.be/_lib/files/European_Code_of_Conduct_for_Clearing_and_Settlement.pdf.
8 Ibid, p 1.
9 See infra under 'The Giovannini Group Report'. Barrier 2 concerns restrictions at a national level on the location of clearing and settlement and Barrier 10 concerns restrictions on the activity of primary dealers and market makers.
10 For an extensive analysis of the Price Transparency Principles set in the European Code of Conduct on C&S, see Report on the Implementation of Price Transparency Measures at http://www.fese.be/_lib/files/Implementation_report_Price_transparency_final.pdf.
11 European Commission, Internal Market and Services DG, Improving the Efficiency, Integration, and Safety and Soundness of Cross-border Post-trading Arrangements in Europe, Report to the Economic and Financial Affairs (Ecofin) Council, July 2007, p 2.
12 http://ec.europa.eu/internal_market/financial-markets/docs/code/guideline_en.pdf.
13 See supra fn **9**, p 3.
14 See infra, at **7.3**. As stated in the Access and Interoperability Guideline, at para 2.1, 'a precondition for obtaining full and cost-effective integration in the provision of cross-border post-trading services is the dismantling of the remaining Giovannini and other barriers. Therefore the European and national authorities should continue to work towards the elimination of legal, fiscal and regulatory barriers and encourage supervisory convergence to fully exploit the potential from the Code and this Guideline'.
15 ECB said in 2006, 'The Eurosystem is evaluating opportunities to provide settlement services for securities transactions' (http://www.ecb.eu/press/pr/date/2006/html/pr060707.en.html).
16 The European Commission fully supports the establishment of the proposed single securities system and considers it to be totally compatible with the principles set by the European Code of Conduct on Clearing and Settlement (see European Commission Report to Ecofin, supra fn **11**, p 6).

7.2.4 Article 34(3): further limitation on legitimate commercial grounds

Further, Article 34(3) sets the element of cross-border communication, ie, when there is an overseas element in the relationship of the regulated market and the SSS, as one additional allowable criterion for the imposition of a restriction by the SSS, on the extent of which MiFID takes no position. In other words, an issue is brought forward for setting also the 'legitimate commercial grounds' as one additional reason for which operators of central counterparty, clearing or securities settlement systems would have the right to refuse investment firms the access to those settlement facilities. Thus, taking into consideration the said provision, it cannot be excluded that national law or also the supervising authorities could allow their national SSSs to apply not only risk-related criteria but also wider criteria, utilising the commercial grounds for the differentiation of those criteria between the different types of participants, eg, between local and foreign/remote participants.[1] In any case, however, a wide interpretation of the term commercial grounds would not be correct and it must be accepted that those grounds are legitimate when they do not impinge the rule of Article 34(1) and are in accordance with the spirit of MiFID. Hence, the proportionality test could also be efficient here. Nonetheless, the element of uncertainty does not cease to exist even at this point, which has important effects in the rapid promotion and completion

of the single market of financial services in the European Union, since where there is a different approach to the matter by a national legislator or supervising authority, the whole procedure of verifying the limits of the discretion of the national law when specifying the terms 'legitimate commercial grounds' is time consuming.

1 Loeber, *supra*, pp 26-28.

7.2.5 Facit

What has been expressed above, shows the extent of the matter still remaining open for a realistic achievement of the goals set by the provisions of Article 34. This statement is evidence of the relativity of such provisions, which, due to the wide use of vague legal terms with references to evaluating judgments and scientific criteria, have to a large extent a programming manifesto character. In that way, the provisions of Article 34 do not sufficiently ensure the required legal certainty and predictability as to the access of investment firms to SSSs as well as to the materialisation of the regulated market participants' right to designate SSSs. Thus, an actual legal barrier remains, deteriorating the fragmentation of European securities market. The free designation by investment firms and regulated market participants of the SSS, in which transactions on financial market instruments would be finalised, constitutes the last ring in the whole chain of the transactions in financial instruments being of major importance for the enhancement of level playing field of a single European market.

7.2.6 Systematic incorporation of Articles 35 and 46 into MiFID

The market's and MTF's smooth operation, as a regulated secondary market, includes not only organisation and operation of the market in respect of the conclusion of transactions and trading (Articles 36 and 39), but also the existence of mechanisms which safeguard the finalisation of transactions, eg, their secure settlement. Secondary EU law, despite having exhausted almost any matter which may arise as to the transactions over financial instruments executed in European securities markets, has not yet touched upon issues of financial services' 'infrastructure'. MiFID, apart from the provisions of Articles 34, 35 and 46, does not go into the issue of settlement. Those provisions only outwardly touch upon the issue of settlement, in the form of a general pronouncement, without going into the substance of the issue, which would actually ensure everything that constitutes the object of the theoretical pronouncement.

Articles 35 and 46 constitute the reasonable sequel to Article 34. As has been mentioned, that article establishes the right of the investment firms to choose the security settlement system in which they wish to effect the settlement of the transactions on financial instruments that they conclude. To such a right of the investment firms corresponds the relevant obligation:

- of the securities settlement systems to provide facilities to the investment firms for the settlement of the transactions they conclude on financial instruments (Article 34(1)); and
- of the regulated markets to offer to their members or participants the right to designate the system for the settlement of transactions in financial instruments undertaken on that regulated market (Article 34(2)).

The exercise of the particular right has, however, as a condition the capability of the operators of MTFs (investment firms or market operators) as well as of the regulated markets to enter into appropriate arrangements with a central counterparty or clearing house and a settlement system. Otherwise, the said right of the investment firms would be annulled as it would be limited, in reality, to transactions executed outside regulated markets and MTFs.

7.2.7 Article 35(1): the principle

Article 35(1) is addressed to the Member States, which, as home Member States, are responsible for the supervision of investment firms and market operators operating an

MTF, and imposes the obligation not to prevent those MTF operators 'from entering into appropriate arrangements with a central counterparty or clearing house and a settlement system of another Member State with a view to providing for the clearing and/or settlement of some or all trades concluded by market participants under their systems.' The same apply respectively as to Article 46(1) of MiFID, which is addressed to the Member States which are responsible for the supervision of the regulated markets, and which imposes upon them the obligation not to allow in their legislation the existence of general and absolute limitations as to the possibility of the regulated markets supervised by such Member States 'to enter into appropriate arrangements with a central counterparty or clearing house and a settlement system of another Member State with a view to providing for the clearing and/or settlement of some or all trades by market participants and their systems.'

Due to the fact that MiFID provides neither for a regulatory regime on CCPs and SSSs nor, consequently, for a supervisory authority for them, it is obvious that the described obligation is formulated and addressed to the MTF operators and to the regulated markets, for which regulatory regime and supervisory authorities have been determined.

7.2.8 Restrictions

7.2.8.1 *Appropriate arrangements (paragraph 1)*

In any case, in both these provisions the value of such prohibition to impose general limiting measures, as an absolute measure, is substantially restricted. This derives from the provisions themselves, which make reference to 'appropriate arrangements'. Only if the arrangements to be put in place are appropriate, is the right of the MTF's operators and the regulated markets to choose the settlement systems effective. Hence, the issue arises as to the criteria on the basis of which the arrangements between the operator of an MTF or a regulated market and a SSS shall be characterised as appropriate.

7.2.8.2 *Limits set up in paragraph 2*

Limits for the safeguard of the orderly functioning of the market

The approach of the particular issue is included in paragraph 2 of Articles 35 and 46 in an elliptical manner. Considering the right of the authorities, which are competent for the supervision of the MTF's operators and the regulated markets, to oppose their use of a central counterparty, clearing houses and/or settlement systems, the provision of the second paragraph of the two articles set limits to that particular discretion of the supervising authorities. In other words, they provide that such discretion may only be applied when the imposition of the prohibition 'is demonstrably necessary in order to maintain the orderly functioning' of the MTF or the regulated market.

The issues of securing the sound completion of the transaction, through the safeguard of the settlement, are not uniformly regulated in EU Member States. The usual practice is for the regulated markets to apply risk controlling measures.[1] Regulated markets require their members to provide margin for the purposes of securing the obligations that they undertake at the execution of the transactions. However, the methods of the margin provision, as well as the calculation of its size, differ in relation to the undertaken risk. Certain markets require eg, the creation of a Guarantee Fund, whereas such a mechanism is not provided in other markets. These risk-based margining methods are dependent upon the configuration of the risk positions that result from the type of financial instruments which are subject of the trades, and upon whether they are subject to gross or net processing. Gross risk positions are considered differently than net risk positions. The qualitative and quantitative criteria for the determination of the risk positions relevant for the risk-based margining differ among the markets of the Member States. It is not easy to find a commonly accepted ground for the determination of those elements and sizes. It is, hence, quite difficult to figure out a measure for the determination of the links and arrangements between the settlement systems and the MTFs/regulated

markets as appropriate, as well as of the organisational and operating conditions of those settlement systems as appropriate for the safeguard of the smooth and orderly functioning of the financial markets.

1 CESR/ECB Standard 18 supra **7.2.3**, fns **1** and **4**.

Interference with Article 34(2)

The reference included in the provisions of Articles 35(2) and 46(2) to 'the conditions for the settlement systems established in Article 34(2)' is more useful. Those conditions for settlement systems refer, of course, to particular issues, ie, to the links and arrangements between MTFs/regulated markets and settlements systems (Article 34(2)(a)), as well as to the technical conditions for settlement (Article 34(2)(b)), but do not include particular criteria for the evaluation of such matters. Once again, as has been previously mentioned, vague evaluation terms are used: in Article 34(2)(a), the appropriateness of the links 'to ensure the efficient and economic settlement' of the transactions and in Article 34(2)(b) the appropriateness of the technical conditions used by the settlement under question to safeguard 'the smooth and orderly functioning of financial markets'.

Those criteria of Article 34(2), to which Articles 35(2) and 46(2) refer, are not defined by the latter exhaustively. They are, however, defined as criteria which must obligatorily be taken into consideration by the competent authorities at the assessment of the conditions concerning synergies between MTFs/regulated markets and settlement systems, which are required for the maintenance of the orderly functioning of the MTFs and the regulated markets. As such, there is a set of criteria, seeking the maintenance of the smooth operation of the MTFs and the regulated markets, as well as of the settlement systems. In other words, there is also in this case the recognition of the 'supplementing' character of the settlement systems *vis-à-vis* the operation of the MTFs and the regulated markets, since it is through the settlements systems that the finalisation of the transactions which are concluded in the MTFs and the regulated markets is conducted. The extent of the discretion of the supervisory authorities to intervene, which is in parallel an obligation, is given in Articles 35(2) and 46(2), where it is explicitly stated that such intervention is allowed – but also mandatory – where this is demonstrably necessary in relation to the intended goal. The words 'demonstrably necessary' give the necessary significance of the relationship between the means and the purpose, but also the need for clarity in the determination of the measures which the supervising authorities are able to take. The intervention of the supervising authorities is, in other words, subject to the examination of the proportionality principle: regulatory intervention must be clearly necessary for the safeguard of the smooth operation of the MTFs/regulated markets and the settlement systems.

Facit

The above analysis makes clear the difficulty in determining the criteria, on the basis of which it will be considered whether the arrangements between MTFs/regulated markets and settlements systems are appropriate for the safeguard of their smooth operation. From the wording of Articles 35(2) and 46(2), it seems that the burden of proof concerning the use of restricting measures lies with the supervising authority, in the sense not only of the obligation to justify their use, but also the restriction of the discretion to use them only in cases where these are 'demonstrably necessary' for the maintenance of the smooth operation of the MTFs and the regulated markets. Nonetheless, the non-determination, even in an implementing measures form, of the appropriateness criteria which must be met by the links of the MTFs/regulated markets and settlement systems, as well as the appropriate technical conditions, in relation to the achievement of the legal end (safeguard of the efficient and economic settlement of the transactions and of the smooth and orderly functioning of financial markets) or of the criteria, on the basis of which the appropriateness will be considered, creates legal uncertainty and severely encumbers the cross-border transactions on securities in the EU. It is a fact that the settlement of cross-system securities' transactions is typically more complicated and potentially involves more risk than the settlement of domestic transactions.[1]

1 CESR/ECB Standards, Standard 19 and Explanatory Memorandum, para 197, supra **7.2.3**, fn **1**, p 79.

7.3 INTERACTION BETWEEN FREE ACCESS TO SSS, THE LEGAL REGIME GOVERNING INTERMEDIATED SECURITIES AND THE CSD'S/ ACCOUNT PROVIDERS' FUNCTION AS SECURITIES' REGISTRARS

7.3.1 Introductory remarks

Apart from the issues described above in the analysis of Articles 34, 35 and 46 of MiFID, another important factor renders the issue of the safeguarding of the unhindered access of the investment firms to the SSS facilities highly complex, constituting an important barrier to the freedom on post-trading in financial instruments within the European Union. Such factor is linked to the legal form of the securities, which are mostly held with 'intermediaries' in book-entry form. The latter, as account providers, play in that way a most significant role in the post-trading, as it is through them, that transactions in securities are settled, and thus finalised. The legal regime governing account providers reflects on the securities and the rights emanating thereof. As to dematerialised securities, upper tier account providers undertake registrar functions and establish the link of the holders of accounts with such account holders to the securities issuers. Thus, the role of account holders at any level of the holding pattern is very important for the exercise of the rights of the securities beneficiaries. The above statement influences definitely the post-trading topic, because securities clearing and settlement – and, thus, the possession of rights on securities as a consequence of the transactions concluded over them – goes through account providers. Access to SSS as an open issue in the financial services industry cannot be efficiently dealt with if the role of the account providers in the whole holding pattern is not analysed.

Indeed, in order to comprehend the role of the entities/systems conducting the settlement of the transactions on intermediated securities and, thus, to make all necessary conclusions concerning the right of access to those systems, the role of these entities/systems as account providers must be taken into consideration and analysed.

7.3.2 Securities held with intermediaries and legal risks in the settlement systems

7.3.2.1 The factual situation

Traditionally, securities have been held under direct holding systems, in which case investors had a direct relationship with the issuer, either because they were registered in the records of the securities' issuing company or because they – personally or through their custodian – held certificates in paper form representing securities. Nowadays, the majority of the direct holding systems in the securities markets – under which financial instruments were being conventionally held – have given their place up in favour of indirect holding and transfer systems.[1]

Under the system of direct holding, transfers of securities were unavoidably made by physical delivery thereof in paper form, which rendered such operations complicated and expensive in time and money. The particular system also entailed risk of loss, theft or falsification as the financial instruments had to be physically transferred.[2] In view of these disadvantages, the practice of holding and transferring securities has changed worldwide. Today, most of the financial instruments, previously held in direct holding systems, are now indirectly held through an intermediary. Any physical holding of financial instruments, to the extent it still exists, is centralised in special institutions such as CSDs.[3]

The particular developments have caused not only shake ups but also relative confusion in the legal world. The basic rules on the securities' characteristics, their transfer, and the securities holders' rights, which had been established even when securities were still in paper form, are tested following such developments. Those developments rendered the

established traditional legal framework on securities in a way obsolete. At national level, and in order to reflect the new market reality, several countries have in recent years revised the legal framework governing securities held with intermediaries in book entry form.[4] However, those changes do not – and it is not possible for them to – embrace the whole range of legal matters arising in relation to the new form of the securities as most of the fields of the law include rules concerning securities' related issues which have been drafted on the basis of the securities' old paper form. These principles had been introduced into Member States' legal systems long ago as an indispensable reaction to the apparent and rising new need in the field of commercial transactions, as an improvement over the then existing rules governing property rights in physical movable assets. In other words, as to the civil law jurisdictions, the above mentioned principles constituted the meeting point between, on the one hand, traditional civil law notions of property rights in tangible assets and, on the other hand, the demands of the new, evolving commercial law. The rules emanating from the (revolutionary at that time) meeting of these two strands, reflect fundamental public policy choices such as, for example, circulation of securities. To that extent, several exceptions to fundamental principles of property law have evolved in the context of securities, eg, the exception allowing the bona fide acquisition of property in movables.[5]

Arguably, several legal uncertainties arise concerning the rules applicable to the new legal regime. For example, will the rules on movables apply to dematerialised securities in book entry form or those pertaining to intangible rights? In all states provisions have been established in order to facilitate transactions in tangible movables and securities to the detriment of too strict an adherence to the security of transactions objective. As such, should one seek to apply traditional property law notions on dematerialised securities, one would risk introducing a rigid and inflexible structure apt to deprive transactions of the requisite flexibility.[6] Such a choice in favour of the traditional property law approach would amount to little less than back-tracking, thus marking a return to the former regime prior to the evolution of the enabling securities rules and signifying a wholesale discarding of the instrumentalism pursued by the more flexible rules on material securities.

Under the newly created holding pattern, an investor no longer has a direct link with the issuer and no longer has direct, physical possession of a certificate – if any eg, in immobilised systems – representing the financial instruments.[7] The investor's right in respect of securities is no longer incorporated in a security in paper form, but is entered into the register of a financial intermediary (account provider) who, in his turn, is either directly related to the issuer ie, as the upper tier registrar in respect of such securities, or has his right registered with another financial intermediary, ie, as an account holder in respect of securities kept in book entry form with another account provider having direct access to the issuer or to the issuer's registrar (eg account administrator) or holding the certificates in paper form or any other document representing the financial instruments.[8]

As a consequence thereof, rights in securities in paper form have been substituted by rights in accounts. The implementation of indirect holding systems has rendered the market infrastructure complicated, involving at times a highly sophisticated chain of intermediaries. The rights in respect of financial instruments are only recorded as book entries at the various levels of this chain of holdings.[9]

The interaction of different laws, which are sometimes even based on different legal traditions, governing all players in the chain between the issuer and the investor, through all intermediaries, in whose accounts securities are credited in book entry form, create a number of uncertainties and legal risks in cross-border post-trading.

1 *See* UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities held with an Intermediary, Explanatory Notes, December 2004, p 4 et seq.
2 *EFLMG Report on Harmonisation of the Legal Framework for Rights Evidenced by Book Entries in Respect of Certain Financial Instruments in the European Union*, June 2003 at http://www.efmlg.org/Docs/EFMLG_report_260603.pdf, p 9.
3 *See* in parallel CESR/ECB, Standard 6, supra **7.2.3**, fn **23**.
4 The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities, Position Paper, August 2003, p 8 et seq.
5 Supra, p 13.
6 Ibid, p 14.
7 Cf P Paech, 'Harmonising Substantive Rules for the Use of Securities held with Intermediaries as Collateral: The Unidroit Project', *Uniform Law Review*, 2002-4, 1140-1160, at p 1144 et seq..

8 EFLMG Report, supra fn 2, p 9 et seq. Cf also as to French law, Antoine Maffei, 'De la nature juridique des titres dematerialisés intermediés en droit francais', *Uniform Law Review*, NS-Vol X, 2005-1/2, p 237 et seq; 'The FMLC Report on Property Interests in Indirectly Held Investment Securities: an Analysis of the Need for and Nature of Legislation in the United Kingdom', *Uniform Law Review*, 2005-1/2, p 339 et seq; Michel Romanowski, 'Is a Reform of the Polish Legal Framework Regarding Intermediated Securities useful?', *Uniform Law Review*, 2005-1/2, p 285 et seq; Dorothée Einsele: 'Modernising German Law: Can the UNIDROIT Project on Intermediated Securities Provide Guidance?', *Uniform Law Review*, 2005-1/2, p 251 et seq.

9 EFLMG Report, supra fn 2, pp 9-10.

7.3.2.2 *Securities settlement systems, central securities depositories and intermediaries: lack of interaction between different European legal systems*

In modern indirect holding and transfer systems, intermediaries, as account providers, have a central position in the whole holding pattern, as book entry securities' accounts are necessarily held with them.

According to the accurate Unidroit draft Convention definition, '"intermediary" means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity and includes a central securities depository if and to the extent that it acts in that capacity'.

As stated above at **7.1.2**, a securities settlement system is understood to be any entity and structure that offers settlement services. Due to the fact that securities are today held with intermediaries/account providers, settlement of securities goes necessarily through intermediaries. Such account providers entail CSDs[1] and, in dematerialised securities systems, the upper tier account provider acts mostly as the registrar, a function which – in certain systems – does not entail securities' settlement.

Security settlement systems – and thus account providers – can operate in direct relation with the upper tier CSD – which, in its turn is linked with the issuer – or not.[2] In the first scenario, however, many variations are possible, as for example the one in which the records of the CSD are assimilated to the register of the issuer, or reflect through mirroring the latter's electronic records or, depending on the securities form – eg, bearer securities – constitute the ultimate legalisation for the beneficial owner. In the so-called transparent systems, direct relationships with the issuer occur for example when the upper tier CSD holds in its systems *ex lege* the names of the end investors.[3]

Lex societatis, governing the issuers of securities could be incompatible with legislation governing a CSD or a SSS in case the latter are the subject of a different jurisdiction than the one governing the mentioned issuer. Incompatibility problems could especially arise in cases where the entitlement to the securities held with such CSD originates *ex lege*, eg, where the law refers to the registration of the securities in such a CSD. This happens mainly in dematerialised systems, most of them being domestically driven.[4] Thus, the provisions of the law governing the securities issuer are related only to the registration with a CSD governed by the same jurisdiction due to the lack of harmonisation of the CSDs/account operators regime within the EU.

If legislation governing the issuer and legislation governing the CSD originate from two different jurisdictions and these legislations do not provide the necessary interference, especially where the law awards to the CSD registrar functions as to dematerialised securities, the entitlement of an investor, who acquires securities in a regulated market linked to a foreign SSS could differ from the entitlement in case of a purely domestic transaction, meaning without a cross-border element between the SSS/CSD, the regulated market and the issuer. Such problems could arise also in the case of dual (or multiple) listings of securities in regulated markets of more Member States and can influence the quality of rights acquired through transactions in the different markets.

EU legislation does not regulate the prerequisites either for exercising the activity of book entries keeping or for provision of custodian services, ie, keeping and administrating securities accounts in which rights in and on intermediated securities are registered. The perspective under which most Member States developed rules regarding book entries

keeping through CSDs and providing custodian services was local stock exchange driven and referred mostly to domestic issuers. Most national legislations recognising dematerialised securities provide that public traded securities issued by domestic issuers should be registered with the local CSD, governed by specific legislation, for which often lex societatis property rights, especially with respect to the securities' issuers, are established.

The reason for this is the lack of legal links between issuers and CSDs governed by two or more different legislations, due to the fact that the Member States company legislation governing the issuer, in the absence of harmonisation, cannot establish rights and obligations regarding book entries kept by foreign account providers. These incompatibility problems constitute impediments in the cross-border circulation of securities within the EU. As mentioned above, the provisions of the laws governing the securities issuer are, thus, related only to the registration with an account provider governed by the same jurisdiction and, accordingly, to the settlement of transactions on these securities – especially shares – in such account provider acting as SSS. The ascertained lack of harmonisation of the account providers regime within the EU impedes, on the other hand, the unconditional interoperability of regulated markets and SSS.

This could lead to discriminatory treatment and consist of a barrier to the free movement of securities, since securities, to be admitted in the regulated market of an EU Member State different to the Member State of the registered office of their issuer ('foreign securities'), could be treated differently, after their registration with the SSS/CSD linked with the said regulated market, than domestic securities, eg, securities issued by issuers governed by the same jurisdiction as the one of the CSD. This could affect investors' rights as well as issuers' and intermediaries' interests, creating thus an unacceptable barrier in the European financial markets. Thus, it is not acceptable for an integrated European market that investors' rights on the same securities, where such securities are listed in numerous European regulated markets, differ due to legal incompatibilities depending on the market in which the transaction takes place and, by extension, on the SSS in which the transaction is settled.

As a matter of legal risk, the European Member State jurisdiction which governs SSSs and CSDs (and, in general, account providers) should not be a factor influencing either the decision of an issuer regarding the regulated market in which its securities will be traded, or of an investor regarding the securities he will acquire. That means that the rights deriving from a book entry in the operator's accounts and their exercise should not constitute a discriminatory factor for investor rights against the issuer, based on the jurisdictions governing the account operator and the issuer.

The rights of an investor who holds securities in book entry form through an account provider or through a chain of account providers, against the issuer should not suffer from the interaction of the different European law systems governing the issuer and the intermediaries. That means that European law should cater for the removing of any existing legal and regulatory barriers that may directly or indirectly affect the investors' rights towards the issuer of the securities as well as the securities' circulation due to the interaction of the different European jurisdictions governing the relevant issues, which ought to be handled through European law.

What has been analysed above is directly linked to the topics of Articles 34, 35 and 46 of MiFID, as the settlement systems mentioned in those articles operate also as account providers.

For the promotion of the European single market, access to clearing and settlement systems throughout the Community by investment firms is required,[5] but also the generation of a legal framework actually enabling account providers to participate directly in other Member States' SSSs and CSDs and/or to establish links with European regulated markets for settlement of securities' transactions realised therein, in a manner which guarantees the investors' rights, legal certainty and systemic stability. The realisation of such a legal framework is a prerequisite for the de facto realisation of the theoretical principle enshrined in Article 34 as well as in Articles 35 and 46 of MiFID. Such an attempt is necessary in order to facilitate the free movement of securities within the EU, in view of the perspective that all EU registered issuers could open accounts held with

any EU authorised account provider and that investors' rights emanating from the securities would not be affected by the jurisdiction governing the intermediary, through which they hold their accounts.

1 On the CSDs' operation *see* Loeber, supra, p 5.
2 D Devos, 'Relevance and Implications of UNIDROIT Draft Convention on Intermediated Securities for Securities Settlement Systems', UNIDROIT Seminar on Intermediated Securities – Paris, France 31 January – 1 February 2006, p 36; Loeber, supra, p 5.
3 Cf Lars Afrell/Karin Wallin-Norman, 'Nordic Countries – Direct or Indirect Holdings: A Nordic Perspective', *Uniform Law Review*, 2005-1/2, p 277 et seq.
4 Loeber, supra, p 32.
5 MiFID, Article 34(1).

7.3.2.3 *Identification of legal risks and legal barriers*

Activities on an international level

The existence of several issues concerning the operation of SSSs constituting legal barriers regarding the integration of EU financial markets and the realisation of the Financial Services Action Plan (FSAP),[1] especially in respect of cross-border securities transactions, has been identified in numerous studies and consultative initiatives of recent years.

At an international level, apart from the Recommendations for Securities Settlement Systems issued by the International Organisation of Securities Commission (IOSCO) and the Committee on Payment and Settlement Systems (CPSS) of the central banks of the G10,[2] and the G30 Plan of Action,[3] the Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary[4] as well as the International Institute for the Unification of Private law (UNIDROIT) Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities held with an Intermediary[5] should be noted.

As to the UNIDROIT draft Convention, its main purpose is to determine the key characteristics of a sound system of holding and transfer of intermediated securities and to harmonise on an international level, through a functional approach, the substantive rules governing the securities held with intermediaries throughout the different jurisdictions involved in cross-border transactions of such securities, thus reducing transaction costs and facilitating the smooth global circulation of securities.[6] This ambitious target must deal with the obstacles arising from the fact that the rules of the draft Convention should take into consideration the very different legal systems governing the subject matter and find commonly accepted solutions. The contracting states are, reasonably, not willing to touch upon basic legal notions such as property rights, contract law and securities legislation affected by the Convention, as well as basic principles and operation rules of CSDs and SSSs, since such changes would be connected with major transaction costs. The issue is to reach substantial harmonisation of the relevant rules in order to achieve the goals of the Convention, without affecting the non-negotiable rules and principles of the States. The fear that the Convention could cause trouble to the function of domestic systems creates scepticism and reluctance in some states. Despite the complexity of the matter, the needs for enhancing financial systems' stability and market participants' protection, as well as improving capital markets' allocative and operational efficiency, require decisiveness and boldness in handling this Convention, going through the osmosis of the different legal systems. The end result of the effort will be indicative of the maturity of the global financial society to provide solutions over complex financial issues when the objective's general goals are recognised and accepted by all interested parties.[7]

Regarding the European Union, a non-exhaustive survey follows of initiatives at the European level, which identify issues linked to the integration of the EU financial market and, to that extent, connected to the topics of Articles 34, 35 and 46 of MiFID.[8] These initiatives draw the attention, especially of the European Commission, to the existing insufficiencies and the need for action.

1 Commission Communication of 11 May 1999 on Implementing the Framework for Financial Markets: Action Plan, (COM(1999) 232 final).

2 *Recommendations for securities settlement systems* (Committee on Payment and Settlement Systems and Technical Committee of the International Organisation of Securities Commissions), November 2001, http://www.bis.org/publ/cpss46.htm. The principal goal of the 19 issued recommendations had been to provide guidelines in order to diminish legal and systemic risk in clearing and securities settlement systems, stressing the necessity of protecting investors' assets from intermediary's creditors. Cf also Loeber, supra, p 32.
3 The Group of Thirty, *Global Clearing and Settlement – A Plan of Action, 2003*. See http://www.group30.org/index.htm. The said Plan – in particular Recommendations 15 and 16 – once again stressed the need to deal with global clearing and settlement issues at the level of each state's substantive law, including investors' protection at the custodian's insolvency, applicable encumbrances' enforcement procedures and settlement finality rules.
4 Adopted under the auspices of the Hague Conference on Private International Law, on December 13, 2002. For full text see www.hcch.net. The particular Convention aims at resolving the issue of conflicts of law in the case of indirectly held securities and provides the applicable law where intermediated securities are involved as being the law agreed upon as governing the investor-direct intermediary agreement. However, it has been commonly accepted that issues of different substantive laws in the various states still remain, not having been eliminated by the particular Hague Convention, the signing and ratification of which by EU Member States is extremely doubtful and debatable due to the opposition of several Member States and EU institutions. Regarding the Hague Convention cf Loeber, supra, p 55; Unidroit Position Paper supra, p 11 et seq; and Paech supra, p 1152 et seq.
5 Released in November 2004 together with the related explanatory notes and preparatory papers. The initial text of the draft Convention on substantive rules regarding intermediated securities has been modified by the works of governmental experts in four sessions, which took place from May 2005 to May 2007 in Rome. The final draft of the draft Convention has been put – as sufficiently mature – before a Diplomatic Conference for adoption, which should take place in Geneva in September 2008.
6 See *UNIDROIT Study Group on Harmonised Substantive Rules Regarding Securities Held with an Intermediary, Preliminary Draft Convention on Harmonised Securities held with an Intermediary*, Explanatory Notes, December 2004, p 17 et seq.
7 Cf Loeber, supra, p 53 et seq.
8 For an extensive and analytical report *see* Loeber supra, p 29 et seq.

The Giovannini Group Report

The Giovannini Group was formed in 1996 by financial experts for the purposes of providing advice and recommendations to the Commission as to insufficiencies in the EU financial markets. One of the mandates of the Giovannini Group concerns the identification of the requirements for efficient clearing and settlement arrangements in the EU, in the framework of which the Group has issued two reports.

- The November 2001 Report,[1] which was a diagnosis of the relevant clearing and settlement processes that were at that time applicable, the different systems around the EU and of 15 barriers hindering the cross-border clearing and settlement services within the EU and thus the integration of EU securities post-trading systems. The identified barriers are categorised in three sets:
  - barriers due to differences in technical requirements/market practice;
  - differences in fiscal compliance procedures; and
  - legal uncertainty arising from differences in substantive law.

  The first set of the above barriers is examined by the Clearing and Settlement Advisory and Monitoring Experts' group (CESAME). The fiscal barriers are being addressed by the Fiscal Compliance Experts' Working Group (FISCO).[2] The legal barriers are subject of the works of the Legal Certainty Group.[3]
- The April 2003 2nd Giovannini Report[4] put forward a detailed roadmap for dismantling the 15 barriers. The Report expressed the view that insufficiencies as to the legal framework for clearing and settlement were still among the most serious obstacles to the integration of the EU financial market, and proposed actions to overcome such barriers. In brief, the Report noted that in order for an adequate clearing and settlement infrastructure on European financial markets to be realised, a two ingredient process should be put in place comprising of:
  - a concerted system of initiatives designed to replace the 15 barriers with standards, regulations and laws adequate to an efficient and barrier-free market; and
  - adequate regulatory/supervisory structures that ensure that the benefits of a barrier-free market will be made available to all market participants through low-cost and safe post-trading services.[5]

According to the second Report of the Giovannini Group, among the Barriers identified in the first Report, priority ought to be given to Barriers 2, 5, 9, and 10, as the elimination thereof would be required in order to deliver the widest possible access to clearing and

settlement services, 'fostering a market-led integration of EU clearing and settlement arrangements'.[6]

The Report additionally went into the legal barriers for cross-border transactions which had been identified in the first report of the Giovannini Group, ie,:

- the absence of an EU-wide consistent framework for the treatment of interests of securities (Barrier 13), highlighting different concepts of property and ownership in the EU Member States, and the need for true finality for transfers of securities;
- national differences in the legal treatment of bilateral netting for financial transactions (Barrier 14), with added emphasis on multilateral netting schemes to be established in the context of clearing systems; and
- the uneven application of national conflict-of-laws rules (Barrier 15).

The Report highlighted the fact that Barriers under the second two points above have been lifted upon the issuance of the Collateral Directive 2002/47/EC, but that it remained the case, however, that the Barrier in point one above and the remaining Barriers identified on the first Report will only be eliminated through the modernisation of the substantive rules of the EU Member States. Focus has therein been given to the book entries system and the need for harmonised nature of 'ownership rights', proposing for those purposes the creation of a 'Securities Account Certainty Project' at the level of the European Union.[7]

1 'Cross-border clearing and settlement arrangements in the EU', November 2001.
2 According to the first Giovannini Report, all financial intermediaries established within the EU should be allowed to offer withholding agent services in all of the Member States, so as to ensure a level playing field between local and foreign intermediaries (Barrier 11). Provisions imposing the payment of taxes on transactions over securities at a local level should be abolished to ensure a level playing field between domestic and foreign investors (Barrier 12).
3 All of the above Groups have been formed by the European Commission. For more details *see infra* under **7.3.3.1** and **7.3.3.2**.
4 Second Report on EU cross-border clearing and settlement arrangements, April 2003.
5 In response to the Barriers identified by the second Giovannini Group Report, the ECSDA issued several reports proposing standards which would assist in the removal of certain Barriers concerning corporate action barriers, operating hours, settlement finality etc. *See The ECSDA Response to the Giovannini Report – Barrier 3, Corporate Actions – Part 2 Market Claims*, July 2006; *The ECSDA Response to the Giovannini Report – Barrier 3, Corporate Actions – Part 1 Mandatory Distributions*, 30 June 2005; and *The ECSDA Response to the Giovannini Report*, April 2004.
6 See Giovannini 2nd Report, supra, fn 4, p 5.
7 Ibid, p. 12 s.

The Report of the EFMLG

The European Financial Market Lawyers Group (EFMLG)[1] report on Harmonisation of the Legal Framework for Rights Evidenced by Book-Entries in Respect of Certain Financial Instruments in the European Union of June 2003[2] states that in many Member States neither the rules of substantive law governing securities transactions nor the conflicts of law rules have been brought up to date in an appropriate and concise manner to cope with the innovations that the indirect holding of financial instruments has brought about. The EFMLG report assumes that indirect holding systems can only function properly if a secure holding is ensured throughout all layers of the intermediary chain and if all of the institutions involved work together efficiently and are reliable. In that respect, the EFMLG considers that Community legislation is needed to harmonise the legal regime governing the holding and transfer of financial instruments by way of book-entries, supported by a system of statutory dematerialisation in the EU. A statutory dematerialised holding regime based on book-entries would be instrumental to take full advantage of the vast advances in computer technology.

According to the EFMLG proposal, this legislation must:

- remove the barriers to further integration of the EU internal market for financial instruments; and
- establish the conditions for transfers and cross-border movements of securities, as well as legal certainty for investors when transferring their rights in respect of financial instruments.

1 www.efmlg.org.
2 http://www.efmlg.org/Docs/EFMLG_report_260603.pdf.

7.3.3 Need for further action at European level to remove existing legal obstacles

7.3.3.1 The European Commission's Communication of 28 April 2004 on clearing and settlement

In parallel to other related or similar initiatives that were in progress at the European Union level, the European Commission conducted its own research and consultation towards the establishment of a harmonised clearing and settlement system throughout the European Union. In that respect, it issued two communications, the first one[1] being more of a consultative document and the second being the most substantial as it entailed conclusions and proposals.[2]

The Communication of the European Commission (COM (2004) 312 final) has stated that current cross-border arrangements in the EU are complex and fragmented, imposing costs, risks and inefficiencies on investors, institutions and issuers. Again, within the field of the infrastructure of the EU financial market, the absence of a harmonised legal regime governing the holding and transfer of financial instruments was thought in the Communication to continue to give rise to distortions in indirect holding systems. The measures suggested in the Communication for the elimination of such distortions are the establishment of a group to deal with the Giovannini Barriers, the issuance of a framework directive on clearing and settlement, the setting up of tax and legal sector expert groups, and the effective implementation of competition law. The Communication further signalled that the Clearing and Settlement System's harmonisation, and harmonisation of the legal regime governing the holding and transfer of securities by way of book-entries in the EU, are part of the project on financial market infrastructure of the European Commission, aiming to assist market participants in operating effectively in an integrated EU financial market. Even though the development of such an EU financial market infrastructure was not included in the Financial Service Action Plan agreed for the period 2000-2005, it has now become one of the priorities for the post-2005 period.

Following the issuance of the second Communication mentioned above, the Commission formed and mandated several groups to deal with pending issues in relation to the cross-border clearing and settlement throughout the EU. In this framework, the CESAME Group[3] was established for the purposes of coordinating private and public sector activities with regard to the elimination of obstacles in the sector under discussion and promoting transparency. CESAME has also undertaken the role of communicating with the different experts' groups and also with other international bodies dealing with issues of clearing and settlement of cross-border transactions.

Concerning tax issues the Fiscal Compliance Group (FISCO) was formed, and in terms of the legal matters arising in the case of cross-border clearing and settlement the Commission created the Legal Certainty Group, the basic characteristics and the activity of which are defined below.

1 Commission Communication of May 2002 on Clearing and Settlement in the European Union: Main policy issues and future challenges, (COM(2002) 257 final).
2 Commission Communication of 28 April 2004 on Clearing and Settlement in the European Union – The way forward, Brussels, COM(2004) 312 final. For the full text see http://Europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0312en01.pdf.
3 Clearing and Settlement Advisory and Monitoring Expert Group; *see* Commission press release, 16 July 2004.

7.3.3.2 Legal Certainty Group

As already mentioned, the Commission Communication on Clearing and Settlement of April 2004 proposed the setting up of a group of legal experts to address problems of legal uncertainty identified in the context of considering the way forward for clearing and settlement in the European Union. The main task of the group was to undertake in-depth legal analysis of the issues raised in the Communication and especially of the following three identified problems of legal uncertainty:

- the absence of an EU-wide framework for the treatment of interests in securities held with an intermediary;

- differences in national legal provisions affecting corporate action processing; and
- restrictions relating to the issuer's ability to choose the location of its securities.

The Group's comparative survey confirmed that there is indeed a wide diversity among the Member States as to the treatment of interests in securities held with an intermediary. However it considered that the detailed exploration of the following seven core issues was necessary: scope; legal effects of book entries; corporate actions and voting rights; recognition of indirect holdings; moment of transfer; transfer requirements; and priorities. After having explored these topics, the Group concluded that there is legal uncertainty in the way the laws of the Member States interact with each other. More specifically, concerning cross-border trading of securities, it is not possible for the law of one Member State – where the book entries are effectuated – to impose obligations and grant rights to the issuers of the traded securities who are established in and governed by the laws of another Member State. Respectively, it is not possible or efficient for the law of the Member State where the issuer of the traded securities is established to rule on the obligations and rights of the account providers, who are subject to the law of the Member State where the book entries are effectuated. Once again, the opinion was formed that the legal uncertainty caused by the matters aforementioned deprives the cross-border transactions and the clearing and settlement thereof from being efficient and secure.

The conclusions of the Group included the decision that the Commission ought to focus on the creation of a new legislative framework on the legal consequences of book entries of securities, which would introduce a harmonised skeleton with respect to the core issues raised by the Group, excluding the issue of the time of transfer and the transfer requirements. The said legislation should aim at minimum harmonisation of Member States' laws. The Legal Certainty Group was obstinate as to its view that no major reform of the Member States' legal systems should occur. In order to reach the particular goal, the Group considered a range of approaches, but it did not end up with a proposal about the form that the new legislation should take.

The Legal Certainty Group delivered to the Commission on 28 July 2006 advice including a description of principles for new legislation about the legal effects of book entries.