Briefing note
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The Securities Law Directive

The European Commission has issued, for consultation, a set of "Principles" which set out its vision for the long-awaited Securities Law Directive: see http://ec.europa.eu/internal_market/consultations/docs/2010/securities/consultation_paper_en.pdf. Although framed as "principles", their substantive contents have the appearance of draft legal text in many cases, and the purpose of the consultation document is to obtain feedback on a potentially controversial draft directive before a formal Proposal for a Directive is launched into the EU legislative process. In this briefing, we comment on some of the most important "principles". Where we refer to the "SLD", we are expecting that the principles will be translated into articles of the expected Securities Law Directive.

The SLD is an important part of the package of legal reforms which will affect financial firms in the post-crisis world. Its main aim is laudable: to bring the law into line with practice. For many years, lawyers have had to struggle with a disconnect between law and reality, as securities laws in Europe have continued to imagine that securities are pieces of paper "deposited" in vaults, when of course the vast majority of investors' interests exist in dematerialised form, as credits recorded in accounts. The SLD is a valiant attempt to codify exactly what investors get when their securities exist as credits to account. Equally importantly, and of huge significance to the financial sector, the SLD will codify the duties of providers of accounts.

> "This could create complications in the way transactions are effected"

The SLD builds on the common language and key concepts developed by the Geneva Convention, previously known as the UNIDROIT Convention on securities held with an intermediary. The SLD is not a direct response to the financial crisis, as the work done in this field predates the banking crisis. The Directive's geographical scope remains undefined, but it nevertheless aims to achieve a wide range of policy goals, from reducing administrative burdens and facilitating cross border transactions to fostering investor protection and achieving systemic integrity.

Who and what is caught under the SLD?

The SLD aims to offer clarity and certainty in a complicated area of law. Its scope however seems to be very wide – for example, all MiFID financial instruments capable of being credited to a securities account will be covered by the principles, which bring within their remit some

Key issues

- Modernising the law about what investors get when securities are credited to an account
- Scope – derivatives and funds may be included
- Account-providers' obligations and liabilities
- Rules about taking securities as collateral
- Custody pricing rules

unconventional "securities", like derivatives and fund units. It is questionable whether the substantive provisions of the SLD were intended to catch these types of securities.

Similarly, as currently drafted, the term "account provider" includes custodians, escrow agents, nominees, UCITS and AIF depositaries, and potentially company registrars.

An attempt to define a minimum set of rights flowing from securities – causing more problems than it solves?

One of the cornerstones of the SLD is to ensure that the ultimate account holder (UAH) enjoys equal rights with the registered shareholder. Specifically, the draft principles state that the account provider of the ultimate account holder should be bound to facilitate the exercise of rights attached to securities by the UAH against the issuer. The obligations in question include "at least" arranging for the UAH to be the representative of the legal holder for the purposes of exercising rights. The actual "rights" in question are not itemised, but while the commentary mentions dividends and voting, it is clearly intended to apply more widely. The SLD falls short of explaining how the rights are to be conferred, and who is liable for any gaps, leaving this to the national laws of each Member State. The proposals will also limit the ability of account providers to contract out of this principle.

Seeking to equalise the attendance and the voting rights of UAH and registered shareholders may be challenging to implement. Consider, for example, timing issues - the mere process of passing the relevant information down the chain will inevitably leave the ultimate end investor with less time on his hands before the applicable cut-off time. And then in turn, this begs the question of whether one should expect direct and indirect holders to have equal rights.

Similarly, in relation to corporate actions, like for example dividend rights, there is a gap between the record date, when the relevant right arises and the actual payment date. During this time the shares in question may be transferred and the new rules fail to specify which account provider will be responsible if a problem arises. The application of the rules is further complicated where ownership is split (for example, where the securities are held as collateral or lent pursuant to securities lending).

Collateral arrangements: credit risk and priorities revisited?

The draft SLD expressly refers to earmarking and control agreements among its prescribed methods for acquisitions and dispositions, including the methods for taking collateral. "Earmarking" means an entry in a securities account which has the "effect" that the account provider is not allowed to comply with the account holder's instructions without obtaining the consent of the collateral taker. How collateral takers are to ensure that account entries do indeed have such an "effect" remains mysterious. Under the SLD, Member States have discretion as to whether they allow investors to use either earmarking or control agreements; but this is where its flexibility ends: if a Member State chooses to offer both methods, the SLD prescribes that earmarking takes priority.

If the ideas in the draft SLD survive the travails of the legislative process, there could be significant work to do to realign securities collateral arrangements with the new legal framework.

Liability – a bit too strict?

The draft SLD only allows an account provider to credit an account holder's account where the account provider actually holds the relevant securities himself. This could create complications in the way transactions are effected from a business perspective. For example, it appears that "contractual settlement" will become more tightly regulated; securities transferred to a third party under a repo or stock loan will no longer be recordable in a securities account; and an issuer of depositary receipts may no longer be able to issue GDRs in advance of the receipt of the shares in question (what is commonly known as "pre-release").

The SLD takes a very strict approach in respect of discrepancies between credit entries made by an account provider and securities actually held. By imposing a broad liability standard, which, as proposed could amount to strict liability, the SLD will change the risk profile for account providers. It is arguable that where reasonable care has been exercised or where force majeure circumstances exist, the account provider should not be liable.

Moreover, the imposition of a duty on account providers to immediately make up any shortfalls, without being able to pass on some of the costs to account holders, effectively translates into transforming account providers into insurers of the solvency of sub-custodians, which may be located in a third country where equivalent duties and liabilities do not exist. The risks arising from such a situation range from importing systemic risk into the EU to forcing certain participants to exit the

market and/or to offer such services at significantly higher prices in order to reflect the increased risk inherent in the provision of the relevant services.

Fees

The draft SLD imposes cross-border regulation of fees on account providers. This type of regulation harks back to the regulation of cross-border payment services pricing, and will require services provided for ultimate account holders "in respect of cross-border holdings of securities" to be priced identically to services in respect of "comparable" domestic holdings of securities. Precisely what this means has yet to be teased out. But it appears to require account providers to disregard the additional expense and risk of providing services in respect of securities held in a CSD outside the account-provider's country when designing a price tariff; and (as yet) there seems to be no geographical limitation (as there is in relation to payments pricing) to the EEA.

Conflicts of law

The SLD also introduces a fresh approach to conflicts of law, building on previous attempts to clarify the law in this field and giving a final blow to the Hague Convention's approach of selecting jurisdiction by contractual agreement. The SLD attempts to resolve jurisdictional issues on the basis of identifying the relevant account using a list of factors and issues to which PRIMA (the place of the relevant intermediary, i.e. where the "relevant account is maintained") applies. For some account providers, identifying a single location using the list of factors will be challenging. The SLD attempts to overcome this issue by prescribing that in such cases, the choice of forum is to be based on the location from which the relationship with the account holder is handled. This assessment, however, can only be made on the basis of factors which are within the knowledge of the account provider and often unknown to the account holder. The final outcome is far from certain and begs the question as to whether a governing law clause might have been a simpler alternative after all.

MiFID

The parting shot of the draft SLD is to convert account-provision into a fully fledged "investment service" for the purposes of the Markets in Financial Instruments Directive ("**MiFID**"). The policy objective behind this is to ensure that persons providing accounts are duly regulated in the same way as investment firms. Many custodians will already be subject to MiFID regulation, so this aspect will cause little alarm. However, there are some unexpected side-effects of custody or account-provision becoming an "investment service" as contrasted with an "ancillary service", which is the current position. Clients wanting investment services have to undergo a fuller KYC enquiry to ensure that the services are appropriate to the client's expertise and knowledge, and there are more detailed documentation requirements. It is questionable whether these side-effects are intended or indeed necessary.

Conclusion

At this stage it is easy to pick holes in the draft Directive. However, if the deficiencies can be rectified during the consultation process, the objective of clarifying and modernizing the law relating to securities held in accounts will be fulfilled and a useful reform will have been implemented.

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