



OPINION OF THE EUROPEAN CENTRAL BANK
of 24 January 2012
on dematerialised securities
(CON/2012/3)

Introduction and legal basis

On 21 November 2011, the European Central Bank (ECB) received a request from the Luxembourg Ministry of Finance for an opinion on a draft law on dematerialised securities and amending (a) the Law of 5 April 1993 on the financial sector, (b) the Law of 23 December 1998 creating a financial sector supervisory commission, (c) the Law of 10 August 1915 on commercial companies, (d) the Law of 3 September 1996 on the involuntary dispossession of bearer securities, (e) the Law of 1 August 2001 on the circulation of securities and other fungible instruments, (f) the Law of 20 December 2002 on collective placement bodies, (g) the Law of 17 December 2010 on collective placement bodies, (h) the Law of 13 February 2007 on specialised investment funds and (i) the Law of 22 March 2004 on securitisation, (hereinafter ‘the draft law’).

The ECB’s competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the fifth and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions¹, as the draft law contains provisions on settlement systems as well as rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The draft law governs the dematerialisation of securities, to which Luxembourg law applies, whether capital or debt securities issued by companies incorporated under Luxembourg law² or debt securities issued under Luxembourg law by companies incorporated under foreign law. The dematerialisation of securities is designed as an additional option, in addition to the possible issuance of such stock and debt securities in bearer or registered form under the Law of 10 August 1915 on commercial companies. From the date of entry into force of the draft law, the

¹ OJ L 189, 3.7.1998, p. 42.

² Capital securities are defined to include capital securities issued by joint-stock companies under Luxembourg law, including shares and stock, beneficiary shares, subscription rights and common placement fund shares. Debt securities are defined to include financial instruments in the form of bearer instruments and public debt instruments. However, for the application of the draft law, bills of exchange, securities redeemable by number-based lottery draws, as well as shares and stock issued by variable capital pension saving companies, are not considered as securities.

dematerialisation process is available to convert existing bearer or registered securities and to issue new securities in dematerialised form, provided the entire issue is registered with a single liquidation body or central account keeper.

- 1.2 Issues listed on regulated markets may only be dematerialised by liquidation bodies³. Securities settlement systems operated in Luxembourg and subject to the Banque centrale du Luxembourg's oversight, governed by the Law of 10 November 2009 on payment services (hereinafter the 'Law on payment services'), are considered as such liquidation bodies⁴. Non-listed issues may also be dematerialised within central account keepers specifically approved by the Financial Sector Supervisory Commission (hereinafter the 'CSSF')⁵, unless they are already recognised as liquidation bodies⁶. Securities that have been dematerialised within a liquidation body or a central account keeper may circulate freely, including within the accounts maintained by account keepers; account keepers are defined as any person authorised under Luxembourg law to maintain securities accounts, including national or international bodies of a public nature established in Luxembourg and operating in the financial sector. To ensure the integrity of all issues, the CSSF may establish the accounting rules for dematerialised securities maintained by liquidation bodies, central account keepers and account keepers⁷.
- 1.3 The draft law also modernises the framework in the Law of 1 August 2001 on the circulation of securities and other fungible instruments (hereinafter the 'Law on circulation of securities') that governs the holding and circulation of securities, regardless of their form and place of issuance in accounts located in Luxembourg. The draft law aligns the Law on circulation of securities with the Unidroit Convention on substantive rules for intermediated securities of 9 October 2009, and with the expected Union harmonisation of securities law⁸. Moreover, the draft law introduces three additional provisions to strengthen the protection of the security holders' rights. First, it provides that, on bringing liquidation proceedings against an account keeper, the affected holders of the securities accounts immediately acquire the rights to the securities that have been credited to the securities account of the account keeper, without having to wait for the crediting of such securities to their own securities accounts⁹. Second, without prejudice to the separately regulated irrevocability and finality rules¹⁰, failure by one party to deliver or settle vis-à-vis its counterparty, confirmed on the date and under the terms and conditions applicable in the relevant market or fixed by an agreement between the parties or the rules of a securities settlement system, discharges the affected counterparty of its corresponding delivery or payment

3 See Article 4 of the draft law.

4 See Article 20 of the draft law.

5 See Article 21 of the draft law.

6 See Article 25 of the draft law, inserting a new Article 28(11) (2) in the Law of 5 April 1993 on the financial sector.

7 See Article 22 of the draft law.

8 See in particular the European Commission's consultation document 'Legislation on Legal Certainty of Securities Holding and Dispositions' of 5 November 2010, available on the Commission's website at www.ec.europa.eu.

9 See Article 4(2) of the Law on the circulation of securities, as amended by Article 28 of the draft law.

10 See Title V of the Law of 10 November 2009 on payment services.

obligations, without prejudice to the liability of the defaulting party¹¹. Third, if the relevant account keeper proceeds to deliver the securities or to pay the price in place of the defaulting account holder, such an account keeper acquires ownership by way of guarantee of the securities or funds received from the counterparty as consideration¹².

2. Dematerialisation of securities

The ECB welcomes the possibility for dematerialising securities in Luxembourg, as this will contribute to the elimination of the operational complexities and risks related to handling physical securities, and to the reduction of settlement and custody costs, as recommended in the ESCB-CESR Recommendations for securities settlement systems¹³ and the prospective CPSS-IOSCO principles¹⁴. At the same time, the ECB recommends that the Luxembourg authorities monitor Union legislative developments as regards the on-going harmonisation of Union securities law, including the possible introduction of mandatory book entry form for transferable securities.

3. Modernisation of the Law on circulation of securities

3.1 The ECB welcomes the amendments to the Law on circulation of securities, which strengthen the protection and enforcement of rights of the securities holders who maintain securities in a securities settlement system, a liquidation body, a central account keeper or an account keeper in Luxembourg.

3.2 The ECB welcomes in particular the amendment to Article 16 of the Law on circulation of securities, under which the relevant account keeper acquires ownership by way of guarantee of the securities or funds received from the counterparty as a consideration for the securities or the funds that it has itself delivered. This is one of the available solutions to mitigate the credit risk taken by the financial intermediary financing the acquisition of securities by its customers. It has particular relevance to the TARGET2-Securities (T2S), the Eurosystem's future settlement platform, as the legal protection introduced by the draft law will cover, *inter alia*, the credit institutions providing liquidity to their customers in their capacity as settlement banks and refinancing the costs of this activity with the intraday credit received from their Eurosystem central bank. If the customer of the settlement bank is not able to reimburse the liquidity provision at the end of the day, the ownership of this customer's collateral will pass to the

¹¹ See Article 15 of the Law on the circulation of securities, as amended by Article 28 of the draft law.

¹² See Article 16 of the Law on the circulation of securities, as amended by Article 28 of the draft law.

¹³ ESCB-Committee of European Securities Regulators (CESR) Recommendations for Securities Settlement Systems and Recommendations for Central Counterparties in the European Union, May 2009; particularly Recommendation No 6: 'Securities should be immobilised or dematerialised and transferred by book-entry in CSDs to the greatest extent possible. To safeguard the integrity of securities issues and the interests of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner'.

¹⁴ Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), Principles for financial market infrastructures, consultative report, March 2011, paragraphs 3.1.2 and 3.27.

settlement bank, hence facilitating the unwinding of the settlement bank's refinancing transaction with the central bank, without increasing the settlement banks' credit exposures.

- 3.3 The amendment to Article 15 of Law on circulation of securities provides that if securities are delivered against cash payment, failure to deliver or settle confirmed on the date and under the terms and conditions applicable in the relevant market, or fixed by an agreement between the parties or the rules of a securities settlement system, discharges the parties from their delivery or payment obligations without prejudice to the liability of the defaulting party. The ECB understands that this provision is proposed to address specific situations encountered in the present financial crisis where transfer orders duly entered into a system, in respect of a counterparty against which insolvency proceedings were subsequently brought, remained unsettled and suspended in the said system, as the insolvent counterparty could not discharge its obligations and the parties could not immediately agree on the bilateral cancellation of such transfer order. The proposed amendment reflects a policy proposal according to which the failure to deliver or settle the underlying securities transaction will automatically discharge the parties from carrying out the corresponding transfer order within the system. The abovementioned provision is 'without prejudice to the separately regulated irrevocability and finality rules'¹⁵, as derived from Article 3(1) and Article 5 of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems¹⁶. In this respect, the ECB understands that the proposed provisions aim to mitigate the effects of the strictly applied principle of irrevocability in a manner which decreases the risks related to unsettled transfer orders. The ECB recommends clarifying the scope and the relationship of the newly introduced provision with regard to the settlement irrevocability safeguarded by Directive 98/26/EC. In addition, to avoid uncertainties that may be associated with the implementation of this proposed amendment, proper coordination should be ensured between the parties to the securities transaction that may agree on the date and conditions of settlement in their bilateral agreements and the securities settlement system that may provide similar provisions in its rules, and also the T2S operator that may provide the technical settlement platform on which the transfer order will be processed. If such coordination is not in place, the parties may agree that they are discharged from their obligations on date S, but the securities settlement system and, as a consequence, also the T2S operator may have no knowledge of this agreement. In such situations, the securities settlement system, and consequently T2S, may continue to attempt to settle the transaction after date S which may produce legal uncertainty as to the status of such transaction. The ECB recommends that the draft law elaborates how the proposed statutory discharge of obligations can be aligned with the rules of the operator of a securities settlement system.

¹⁵ See Title V of the Law of 10 November 2009 on payment services.

¹⁶ OJ L 166, 11.6.1998, p. 45.

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This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 24 January 2012.

[signed]

The President of the ECB

Mario DRAGHI