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FINANCIAL MARKETS LAW COMMITTEE

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Legal assessment of the arguments relating to the signing of the Hague Securities Convention – the need for, and benefits of, the Hague Securities Convention

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1. Introduction and executive summary

(a) Introduction

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

1.2. In May 2005 HM Treasury sought the view of the FMLC on the question whether there is legal uncertainty in relation to the law governing indirectly held securities and whether, if so that legal uncertainty has significant commercial impact. HM Treasury wished these questions to be addressed in the context of the European Commission's ongoing legal assessment of the merits of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary ("the Hague Securities Convention").[1]

1.3. In July 2005 the European Commission also expressed an interest in receiving the FMLC's comments on the Hague Securities Convention's contribution, if any, to legal certainty in the field of indirectly-held securities. This paper responds to those requests and sets out the FMLC's analysis of the issues, providing a legal assessment of the arguments in relation to implementation.

1.4. In summary, the conclusion of the FMLC is that the Hague Securities Convention provides a workable solution to a significant issue in the international financial markets. There is currently no common legal approach internationally to the determination of the applicable law governing proprietary issues affecting securities holdings in securities accounts maintained by an intermediary.[2] This absence of a common approach leads to serious legal uncertainty in the cross-border securities markets in relation to the proprietary issues affecting securities held in securities accounts, which, in the FMLC's view, it is necessary to resolve as soon as possible and in a way that is consistent across all international financial markets around the world. Further, the FMLC considers that the approach adopted by the Hague Securities Convention is one that provides a satisfactorily high level of legal certainty in identifying the applicable law and therefore provides a suitable and effective solution to the issue.

1.5. The key points in the reasoning of the FMLC are set out in the following sections and are summarised below.

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1 The Convention was adopted by the Nineteenth Diplomatic Session of the Hague Conference in December 2002. The European Council is currently considering whether to comply with the Commission's recommendation that the Hague Securities Convention be signed by Member States and the Commission on behalf of the Community.

2 On an EU level, there is a limited common approach provided by the Settlement Finality Directive and the Collateral Directive. However, these two directives do not address all the circumstances where it is necessary to determine the applicable law in relation to proprietary issues.

(b) Executive summary

1.6. The holding and transfer of (interests in) securities in the international financial markets has become increasingly complicated, in light of the immobilisation of securities. Investors today generally hold interests in securities through securities accounts with intermediaries, usually without those investors (or even the intermediaries acting on their behalf) having possession of physical certificates or having their names recorded on the relevant securities register. This development has led to legal uncertainty in the cross-border environment, with a negative commercial impact, about various features of securities and securities transactions including uncertainty about the applicable law that governs proprietary issues affecting securities transactions.

1.7. One traditional approach for determining the governing law of such issues is to ascertain the location of the security (*lex situs*/*lex rei sitae*). However, whilst a sensible and convenient approach to directly-held securities evidenced or constituted by bearer certificates or by a register maintained by or on behalf of an issuer, the organisation of modern international financial markets renders this approach more problematic: on the one hand, the intermediated security which is the subject of the transaction can only be accorded a location in a purely fictional sense; on the other hand, any physical manifestation of the security itself – and the location thereof – is remote from the steps under which any disposition of the investor's interest in the security is effected and recorded. As a result, the *situs* of the security is not a satisfactory criterion for ascertaining the governing law of proprietary issues affecting a transaction in an intermediated security.

1.8. A more modern approach is to link the applicable law to the securities account in which the investor's interest is recorded (the so-called "place of the relevant intermediary approach" or "PRIMA"). However, if PRIMA is formulated by reference to the location or *situs* of the securities account, similar problems arise. It is a heuristic fiction to speak of the *situs* of an intangible intermediated interest in a security, but it is equally difficult to allocate a *situs* to an account, which has no unique corporeal manifestation.

1.9. The negotiations that led to the Hague Securities Convention considered these approaches and, in light of their drawbacks, eventually settled on an approach centred, and subject to certain defined parameters, on the choice of law by the parties to the account agreement.

1.10. The benefits of implementing the Hague Securities Convention, and in doing so with the minimum of delay, are several and considerable:

(a) the approach adopted by the Hague Securities Convention provides a satisfactory solution for ascertaining the applicable law, as it provides a mechanism that promotes a high level of certainty. This certainty will provide stability to international financial markets and allow financial institutions to better manage the risks they face when dealing in securities;

(b) the adoption, in all major financial jurisdictions, of a common approach to ascertaining the applicable law as a matter of the conflict of laws is a step that is beneficial to take now and should not be delayed while other projects that seek to harmonise the substantive law in relation to securities held with an intermediary are progressed. Such projects will offer significant advantages in the long term, but give no reason to delay implementation of laws that will clarify significantly the separate, but fundamentally important, issue of the law that governs proprietary issues affecting intermediated securities; and

(c) the Hague Securities Convention creates an environment that will facilitate work to create common IT platforms for cross-border securities transactions at lower cost. By creating a certain and controllable mechanism for ascertaining the applicable law, common platforms for clearing transactions through securities accounts on a cross border basis can be developed, without causing concern that the "physical" location of this platform might influence the law governing proprietary issues affecting securities credited to the accounts maintained on the platform.

1.11. The FMLC does not consider that the concerns that have been raised by certain parties in relation to the implementation of the Hague Securities Convention are sufficient to warrant a delay in implementing the Hague Securities Convention. In particular, the FMLC notes:

(a) the mechanism for ascertaining the applicable law in the Hague Securities Convention does not have the effect of moving the *situs* of securities held with an intermediary;

(b) the Hague Securities Convention does not create an environment that will lead to unfairness to small banks in their dealings with larger banks – this is already a challenge faced by small banks, which will not be prejudicially affected by the Hague Securities Convention;

(c) the Hague Securities Convention does not prevent a regulatory approach, where determined appropriate by the relevant regulatory authority, to ensuring that proprietary aspects of securities accounts in securities settlement systems are governed by the same law. Therefore, any need to reduce systemic or other risk that may be caused by operators choosing different governing laws to apply to different accounts within their systems can be addressed by mechanisms (such as the use of regulatory consequences, like the unavailability of designation, authorisation or recognition, for a choice made by an operator and its participants of a non-Member State law to govern proprietary issues) that do not breach any obligations a State may have to give effect to the parties' choice of law under the Hague Securities Convention.

2. Is there uncertainty?

(a) Uncertainty relating to the *situs* of the (interest in the) security

2.1. *Lex situs* is a rule of the conflict of laws which applies to determine the law applicable to proprietary issues affecting an asset by reference to the location of the asset concerned. In particular, the *lex situs* rule is commonly applied in determining the applicable law in relation to proprietary aspects of tangible property. It is the rule which the English courts have traditionally adopted in relation to proprietary aspects of transfers in directly-held securities.[3]

2.2. The *lex situs* approach raises a number of issues when applied to (interests in) securities in the modern context of international financial markets. We discuss below the issues that are raised from the point of view of English law. However, we consider that the issues are generic to all systems of law that look to the *lex situs* to ascertain the applicable law for the proprietary aspects of security transfers. Therefore, the analysis below is valid for jurisdictions other than England and Wales.

2.3. The *lex situs* approach was sensible and practical when securities were held in certificated form by their owners and transfers of the same were effected by physical delivery of the certificates, or in the case of registered securities, by surrender of the certificates to the issuer for registration of transfer on a register maintained by or on behalf of an issuer in the place of incorporation of the issuer. It was natural and logical to treat bearer certificates, and registered securities transferred with certificates delivered up to the issuer or its registrar, in the same fashion as any other tangible moveable object of property for the purposes of conflict of laws. The applicable law would be:

(a) in the case of bearer securities, the law of the place of the certificates representing the securities at the time of transfer;

(b) in the case of registered securities, either:
  - (i) the law of the place of the issuer's incorporation or organisation; or
  - (ii) the law of the place where the register is maintained at the time of transfer.

2.4. *Lex situs* was identified as the correct principle for the identification of the applicable law in relation to questions of competing transfers of securities by the English Court of Appeal in *Macmillan Inc. v. Bishopsgate Investment Trust & Others (No. 3)*[4] ("*Bishopsgate*"), the leading authority on this issue in

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3 It should be noted that the *lex situs* rule is not the only rule that has been suggested to govern the law applicable to the proprietary aspects of dealings in intangible property, including transfers in directly-held securities. An alternative solution is to apply the *lex creationis*, which is the law under which the interest in question is created (typically, that governing the instrument or relationship in which the interest originates). Most obviously, Article 12(2) of the 1980 Rome Convention on the Law Applicable to Contractual Obligations adopts this approach in connection with the assignment of contract debts.

4 [1996] 1 WLR 387

England and Wales. It was held in that case that the applicable law is, where the securities are registered securities, the location of the register or of the incorporation of the issuer. Where they are negotiable, it would be the location of the pieces of paper constituting the negotiable instrument at the time of transfer.

2.5. One of the principal grounds for such reasoning was that it was said to provide certainty. However, even at the time of this decision in 1996, it was recognised by the Court that this approach could become burdensome. Lord Justice Auld stated:

> It may be burdensome in a single transaction involving transfers of parcels of shares in a number of countries to have to check the law of the place where each is at the time of transfer.[5]

2.6. In any event, the *Bishopsgate* decision was based on unusual facts, in that the parties were in that particular case able to, and did, trace the relevant securities up the chain of intermediary holdings and ensure that their interest was recorded and perfected at higher levels in the chain. Even at the time, this was unusual and it would in other cases be practicable only in exceptional circumstances (and probably only at considerable cost). The *Bishopsgate* decision did not purport to lay down a general rule for establishing the law applicable to interests in securities in the form of balances credited to a securities account with an intermediary and should not be viewed as having done so. It is the overwhelming prevalence of indirect holdings of securities that has motivated and necessitated the new approach of the Hague Securities Convention.

2.7. In recent decades, the simple pattern of holding and transferring securities described above has altered in a fundamental manner. The investor who actually holds physical certificates or is registered in the issuer's books as the holder of the securities is nowadays the exception.

2.8. Investors today typically hold through accounts with brokers and banks, which in turn hold through accounts with other intermediaries and they ultimately through accounts maintained by central securities depositories ("CSDs") or, in some cases, directly with the issuer. Alongside the development of this indirect (or intermediated) holding structure has been the complementary trend of dematerialisation of the underlying securities with the result that they are no longer represented and transferred by certificates and other written instruments, but rather by a book entry on records maintained either by a designated record keeper or by or on behalf of the issuer and in response to electronic transfer instructions.

2.9. In a system of indirect securities holdings, it is widely recognised that the *lex situs* approach no longer provides a workable or certain conflict of laws solution. Even when one is dealing with a single security, in order to identify the relevant *situs*, it is necessary to "look through" tiers of intermediaries to get to the level of the issuer, the register or the actual certificates, and even then, there is the question in each relevant jurisdiction of which of these is

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5 [1996] 1 WLR 387, 412 a-b

determinative of the *situs*. This is even more problematic when the register itself is not easily identifiable with a single location, as is the case with the increasing number of electronic registers which are serviced by more than one office of a registrar and may also, in technical terms, have been "offshored" to a completely unrelated jurisdiction.

2.10. The practical impossibility of the "look-through" approach becomes even more apparent if one examines the current practice of investors providing collateral which is commonly in the form of diversified portfolios of securities issued by companies organised under the laws of a number of different jurisdictions or by various government and governmental agencies. Any such collateral provision would, under the look-through approach, require the collateral taker to satisfy the domestic law requirements, in relation to perfection and similar proprietary issues, for each State where the issuer of a component security of the portfolio is organised for any transaction involving the provision of collateral.

2.11. Thus, for a portfolio containing the securities of thirty different companies incorporated in thirty different jurisdictions, each with divergent rules on whether place of incorporation, location of the register or of the actual certificates is the relevant *situs* (and the actual location of each of these being different in each case), the collateral taker would be placed in an impossible position. It is apparent that the collateral transaction will be seriously endangered or become prohibitively costly, if not impossible, to execute due to the legal uncertainty created by utilising the *lex situs* approach. This already terribly complicated situation is exacerbated by the fact that the composition of such portfolios often changes on a daily or hourly basis.

2.12. In modern markets, therefore, the *lex situs* approach makes it practically impossible for a collateral taker to manage perfection and other proprietary issues affecting its interest in a portfolio of intermediated securities.

2.13. Where such interests in securities are held in a fungible (omnibus) account, as often occurs both in the case of global custodians and CSDs, the situation is exacerbated further in that at the level of the issuer's register and, indeed, at each stage above the primary investor relationship (investor-broker/bank), there is typically no record of an investor's interest in the underlying securities. This situation is potentially made even more complicated by the effect of multilateral netting in clearing systems.

2.14. It is therefore important to recognise that present-day reality renders notions of "location", as applied to (interests in) securities, at best artificial and at worst impossible to apply, creating significant uncertainty. For intermediated systems with portfolios of securities of an ever-more international mixture, the certainty market participants require can only be achieved by a change (for conflict of laws purposes only) to focus on factors involving the relationship between the investor and the intermediary, rather than the underlying securities themselves.

(b) Uncertainty in relation to a "location of securities account" approach and where an account is located

2.15. Given the uncertainties of the *lex situs* approach and the need for a change of focus, it was initially suggested that the Hague Securities Convention should determine the law applicable to proprietary rights arising in relation to securities held with an intermediary by reference to the place where the relevant securities account is maintained. This formulation is reflected in the approach taken under existing European legislation, including the Settlement Finality Directive, the Collateral Directive and the Reorganisation and Winding-Up of Credit Institutions Directive.

2.16. However, there is no single criterion for determining unequivocally and with certainty the location of an account – the application and interpretation of any criteria is not only complex, but varies from jurisdiction to jurisdiction.

2.17. If simple geographic criteria are to be applied, it is first necessary to determine what an account is in order to determine its location. An account could, most obviously, be considered as the physical record maintained by an intermediary of securities holdings. However, consider an intermediary that is a multi-national organisation that:

(a) dealt with the request from its customer for a securities account to be opened in relation to the London market from its New York office;

(b) has outsourced the maintenance of the account to a service provider in Hong Kong;

(c) who, in turn, maintains its records on IT infrastructure which is located in multiple jurisdictions (and for backup purposes undisclosed locations);

(d) holds the underlying securities with a multi-national custodian in several jurisdictions (in different forms including wholly dematerialised holdings);

(e) provides various ancillary services such as the provision of account statements and the sending of dividend cheques from an administrative base in Dublin; and

(f) provides the customer with on-going advice from its call centre in New Delhi.

2.18. Alternative definitions of what constitutes an account could be formulated. However, irrespective of the definition used, the inevitable conclusion of considering any scenario as complex as that set out above (which, although complex, represents the reality of modern day market infrastructure) is that a test for the location of an account based on physical records and geographical location is unlikely to be workable, relevant or certain. It is better to view an account as not, in any real sense, having a "location". This approach is further supported by the fact that the nature of an account and the interest that it constitutes or evidences in or in relation to the underlying security, which is a substantive law issue unaffected by the Hague Securities Convention, is not uniform in all jurisdictions. Generally speaking, an account is the product of an agreement between the account holder and the intermediary to record in book-entry form securities deposited with the intermediary, governed by a law which will generally give certain rights (whether as direct ownership rights or a bundle of intangible property rights) against the intermediary, a fact which the Hague Securities Convention recognises in the principle of choice of law by the intermediary and account holder. It is the account agreement that will govern, as between the intermediary and investor, the mechanics of how the investor's interest (whatever its nature may be as a matter of applicable substantive law) is to be constituted or evidenced and transferred.

2.19. Other more complex criteria such as tax, regulatory and accounting requirements that seek to locate a securities account (assuming it could be defined) for their own purposes could be used, instead, to determine the location of a relevant account or office. However, each of these criteria will inevitably lead to different results and, moreover, these criteria provide no uniform rule whatsoever given that the systems against which they operate differ significantly from jurisdiction to jurisdiction (not only globally but within the EU). Furthermore, in some jurisdictions, these requirements may not exist at all. Of greater concern is that applying these criteria would be arbitrary and illogical – there is no policy reason why tax, regulatory or accounting requirements should determine the law that is most appropriate to govern the **proprietary** aspects of an intermediated securities holding.

2.20. So, in the context of: (a) multi-national organisations; (b) the use of information technology; and (c) outsourcing, any attempt at determining uniformly and with certainty, precision and consistency the geographical location of a securities account or the office of an intermediary at which an account is maintained is futile and is an invitation to litigate.

2.21. Conversely, the Hague Securities Convention's approach, based on the choice of law under the contract between the intermediary and the account holder, offers a robust and workable solution to the legal and practical problems set out above. Therefore, whilst we agree with the conclusion of the European Central Bank ("ECB") that the existing European legislation has been an improvement in legal certainty and addresses systemic risk in relation to certain areas of activity in the EU, we disagree with the ECB's implication that it is a sufficient improvement. In addition to dealing with the uncertainties discussed above, the Hague Securities Convention, unlike the current European law rules, covers a full range of parties and dispositions and is global in its application, thereby extending the benefits of certainty across the global financial community. It also has the advantage of adopting a solution to such issues which is not unfamiliar in the context of international conventions – compare, for example, Article 12(2) of the Rome Convention on the Law Applicable to Contractual Obligations.

3. Benefits of the Hague Securities Convention

(a) Historical development of Hague Securities Convention and its benefits

3.1. The growth of cross-border securities transactions has been substantial in recent years. The volume, value and technological advancement of these transactions indicate the need for conflict of laws rules identifying the substantive law applicable to the various proprietary aspects of the transactions: i.e. how the securities are held, transferred and pledged. The gains in legal certainty and predictability would constitute a significant benefit deriving from such rules.

3.2. At present, in the absence of the Hague Securities Convention, there is no uniform worldwide[6] conflict of laws rule to identify the law governing the proprietary aspects of a disposition of interests in securities[7] and in particular:

(a) completion of a transfer of title over interests in securities;

(b) creation, perfection and enforcement of pledges over such interests;

(c) issues of priority between competing dispositions.

3.3. The overriding goal of the Hague Securities Convention is to enable financial market participants to ascertain readily and with a high degree of certainty the law that governs certain aspects of securities transactions in which they are involved.

3.4. To achieve this goal, it is necessary to reflect market reality. In the vast majority of securities transactions the investor's interest is no longer directly recorded with, or represented by a physical security directly issued by, the issuer. Rather the investor's interest in or in relation to the underlying securities is recorded in a securities account with an intermediary, which in turn has a securities account with another intermediary, and so on up the chain until an intermediary either is recorded as the registered owner on the books of the issuer or the issuer's official record-holder or holds the certificates or other documents of title representing the securities.

3.5. The concepts of physical possession and delivery do not operate satisfactorily in the context of indirectly held securities, where there is no actual possession or delivery of the securities by or to the investor. Indeed, in modern systems operating in the global financial markets, investors commonly do not hold certificates in relation to the securities they own.

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6 A partial approach has been developed in European law through the Settlement Finality Directive and the Collateral Directive. However, these provisions only cover a limited number of the range of circumstances where proprietary aspects of securities held with intermediaries are relevant.

7 The Hague Securities Convention would not apply if no intermediary is involved and the securities are held directly by the investor.

3.6. However, as discussed above, the traditional conflict of laws rule for determining the enforceability of a transfer of property or a pledge of securities is the *lex rei sitae* criterion, which would point to the law of the place where the security is located. The application of this criterion requires the identification of the place where the securities actually are maintained.

3.7. As has been explained above, there are a number of difficulties in relation to *lex situs*/*lex rei sitae* approach:

(a) the traditional approaches to attributing a *situs* to a security (location of the certificate, place of register, jurisdiction of incorporation of issuer), when applied to an indirect holding system, "look through" tiers of intermediaries to the level of the issuer, register or actual certificates;

(b) where securities are held through "fungible accounts" (i.e. *omnibus* accounts), as is very commonly the case for global custodians, there is no record of an individual investor's interest in relation to the securities identified in the issuer's register and no record with any intermediary other than the one with whom the investor has a direct relationship;

(c) furthermore, there are practical difficulties in determining what a securities "account" is and where it is located, especially in the case of multi-branch custodians operating through large decentralised networks or outsourcing the services relating to securities accounts (see section 2(b) above);

(d) a "look through" approach also encounters practical difficulties, as explained above (see section 2(a)), in identifying the CSD that actually stores the certificates, and in having to address the requirements established by several jurisdictions for collateral in the form of interests in respect of a diversified portfolio issued in different jurisdictions.

3.8. The negotiations leading to the Hague Securities Convention reveal that there is no criterion generally acceptable on a global basis for the vast majority of transactions in order to determine with precision the location of a securities account.

3.9. The early drafts of the Hague Securities Convention adopted an approach based on the location of the account. This approach was rejected because, as seen above (see section 2(b)), it was not feasible to identify the location of an account or even the location of where an account is maintained in many instances.

3.10. Consideration was given to the possibility of using tax, regulatory reporting or accounting requirements to determine the location of a securities account. This approach was unanimously rejected because these requirements are not uniform and are not necessarily related to the law that should govern proprietary aspects of intermediated securities holdings.

3.11. There was consideration of a "branch/office" approach, attributing relevance to the location of the branch of the intermediary that actually carried out the functions of maintaining the account. However, because an account is intangible, it does not have a geographical location and thus it is not readily possible to identify an obvious geographical link between the account and the location of the intermediary "maintaining" that account. This point is even more relevant when it is appreciated that it can often be difficult to identify the relevant operation that is the characteristic performance of an operator's "maintenance" of a securities account.

3.12. If the criterion for determining the applicable law were the location of the securities account or the location of a particular office where the securities account is maintained, certainty could not be achieved since it is not practical to address all activities that constitute maintenance of an account and, in modern commercial practice, to "locate" those activities in a single place.

3.13. Thus, the approach adopted by the Hague Securities Convention departs from the focus on attributing a "location" to an intermediary or a securities account. Instead the Hague Securities Convention favours an approach giving effect to an express agreement on governing law between an account holder and its intermediary and adding a "qualifying office" requirement (i.e. agreement plus "reality test" approach). In so doing, the Hague Securities Convention focuses on the relationship between the relevant intermediary and the account holder with respect to a particular securities account, and refrains from any attempt to "locate" a securities account. It is this relationship which governs the steps by which the investor's interest (whatever its nature may be as a matter of applicable substantive law) is to be constituted or evidenced and transferred.

3.14. Article 4 of the Hague Securities Convention provides that the law applicable to the issues specified in the Convention is the law expressly agreed by the parties as the contractual governing law of their account agreement or, if the parties expressly specify another law to govern the Convention issues, that other law, provided, in either case, that the law chosen by the parties is the law of a State where the intermediary has an office ("Qualifying Office"). This office must be either engaged in a business of maintaining securities accounts or, alternatively, identified as maintaining securities in that State.

3.15. The Hague Securities Convention's fall back provision, in the absence of an express agreement or a Qualifying Office, refers to: (a) the law of the place of the office that a written account agreement expressly identifies as the office through which the relevant intermediary entered into the account agreement; (b) the law of the place of incorporation or organisation of the relevant intermediary; or (c) the law of the principal place of business of the relevant intermediary.

3.16. The principal attributes of the approach adopted by the Hague Securities Convention may be summarised as follows:

(a) the approach dictates that questions of creation, perfection/completion of rights against third parties, priorities and realisation of interests in respect of securities, be governed by the law agreed between the account holder and its intermediary;[8]

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8 Not, it should be noted, the law agreed between the parties to the relevant transaction, unless it happens to be a transaction between an account holder and its intermediary. The use of the

(b) the approach situates all of an investor's interests with respect to a portfolio of securities in a single jurisdiction, even if the issuers, registers and certificates related to the underlying securities are situated in different countries;

(c) the approach applies regardless of whether a disposition is made by way of sale or by way of a collateral transaction and, in the case of a collateral transaction, regardless of whether the disposition takes the form of a pledge or a transfer of title;

(d) the approach applies regardless of the particular legal status of the parties to a disposition. It also applies regardless of the jurisdiction in which any party or intermediary is formed or located;

(e) the approach provides a harmonised, general, universal conflict of laws regime applicable to all securities intermediaries. The solution provided by the Settlement Finality Directive (Article 9.2) and the Collateral Directive (Article 9) is limited to collateral transactions in the context of payment and settlement systems/central bank operations or (subject to the nuances of national implementation) applicable only to financial or market counterparties more generally, and therefore does not represent a universal solution where proprietary issues are concerned;

(f) the approach reaches an *ex ante* certainty about the substantive law applicable to the proprietary rights. It offers a simple criterion for intermediated indirect holding systems regardless of the location of the underlying security instruments;

(g) recognition that a single identifiable law governs the perfection of a transaction affecting intermediated securities may, in practice, allow a party to reduce the number of filings that it makes in respect of that transaction. In the absence of a universal and certain conflict of laws rule, it is not uncommon for collateral-takers to make filings (by way of perfection of the transaction) in a number of different jurisdictions whose laws might potentially govern perfection issues – at least where the protections afforded to arrangements under the Collateral Directive are not applicable to the transaction. This unnecessarily increases costs and is administratively inconvenient. In addition, where for example the *lex societatis* imposes a filing requirement by way of perfection of a transaction entered into by a corporate collateral-giver in respect of its "overseas" intermediated securities, the Hague Securities Convention will do away with the need to make such a filing under the laws of both the place of incorporation of the collateral-giver and the applicable overseas law.

3.17. The Hague Securities Convention reflects the need to formulate a conflict of laws rule that reduces risks, reflects existing and foreseeable market practice and permits market participants to determine in advance which law governs all the issues falling within the scope of the Hague Securities Convention.

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phrase "party autonomy" in relation to the Hague Securities Convention test may be misleading in this respect.

(b) It is not practicable to wait for harmonisation of the substantive law relating to indirectly held securities

3.18. It has been suggested that it would be advisable to wait for harmonisation of the substantive laws relating to securities held through intermediaries, which is currently being considered by UNIDROIT (Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary).

3.19. However, seeking uniformity on conflict of laws is a more realistic objective than seeking comprehensive harmonisation of substantive laws. Further, the current efforts at harmonising substantive laws will not lead to a complete unification of the laws governing all proprietary issues affecting securities held with intermediaries. In such circumstances, a conflict of laws rule will still be necessary, as there will remain proprietary issues potentially governed by conflicting substantive laws where a conflict of laws principle will be required to determine which law is to apply to that issue.

3.20. It has been suggested (see the papers prepared by the French Treasury, entitled "Impact on Substantive Law", copies of which were circulated to members of the EU Legal Certainty group on 18th April 2005) that the Hague Securities Convention could affect national substantive laws, e.g. the entitlement to the exercise of shareholder rights such as the right to vote and to attend general meeting.

3.21. The Hague Securities Convention does not impose any change on a State's substantive law; the Hague Securities Convention is confined to conflict of laws issues.

3.22. The Hague Securities Convention expressly excludes from the issues determined by the Hague Securities Convention law the rights and duties of an issuer of securities or of an issuer's registrar or transfer agent. This exclusion encompasses the duties of an issuer with respect to all corporate actions, including voting rights, dividend rights and registration rights and the rights of an issuer to define the steps for achieving good discharge of a note, bond or other debt security. Furthermore, the Hague Securities Convention has no impact on regulatory schemes relating to the issue or trading of securities, regulatory requirements placed on intermediaries or enforcement actions taken by regulators.

3.23. It has also been suggested that the EU might decline to proceed with the proposed Hague Securities Convention and could focus instead on an EU regime for both conflicts and substantive laws. In the interim, this would leave EU intermediaries without any uniform solution for the law applicable to securities holdings in the EU. It would also leave unresolved the legal uncertainties regarding this crucial issue for transactions with the rest of the world.[9]

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[9] Current harmonisation efforts such as those undertaken by UNIDROIT and the Commission's own Legal Certainty project will not lead to complete unification of the laws governing all proprietary aspects of book-entry securities and thus there will remain lacunae which will require a conflict of laws treatment in order to ascertain the provisions of the applicable law.

3.24. It has been explained above why the formulation of the PRIMA principle as set out in the Settlement Finality Directive (Article 9.2) and the Collateral Directive (Article 9) has proven to be inadequate in this area because of the difficulties in locating a securities account. Therefore, if the Convention were to be adopted, these existing EU directives would have to be amended. This has always been recognized and was acknowledged by the Commission and the Member States in agreeing the text of the Hague Securities Convention in December 2002.

(c) IT/technical platform issues

3.25. The continuing application of the *lex situs*, or any formulation of PRIMA which is based on the "location" of a securities account, would create potentially insurmountable difficulties for initiatives which aim to lessen the costs associated with the cross-border settlement of securities transactions in the EU.

3.26. For various business, regulatory and tax reasons, a market participant might wish to maintain a legal relationship with its securities intermediary (whether a CSD, global custodian or sub-custodian), but be able to effect settlement of securities transactions with participants who use the services of other intermediaries (whether established locally or in other EU states).

3.27. The costs of cross-border settlement between participants using different intermediaries can be substantially reduced by the operation of the various intermediated services on a single "technical" platform. Such a solution enhances economies of scale and inter-operability between the intermediaries' systems. At the same time, each intermediary operating on such a platform would expect to be able to continue to offer its customers the particular legal and regulatory protections afforded to them under the intermediary's local laws. The intermediary would wish to avoid any risk that the law of the place where the technical platform is located, or the law of the establishment of the "operator" who has day-to-day operation of the platform (under arrangements made with the intermediary), would govern its legal relationship with customers or proprietary issues affecting securities credited to their securities accounts.

3.28. The fundamental problem with the *lex situs* and related "location of account" tests is that they both require a fictional "attribution" of *situs* or location to an asset that has no physical existence. The factors that apply and influence the evolution of the relevant rules to determine *situs* to moveable assets may vary depending upon the nature of the asset concerned, the point in issue and the jurisprudential tools that are available to the forum court.

3.29. The relevant rules that might apply to determine the *situs* or location of a securities account maintained by an intermediary have not been conclusively determined, as far as we are aware, in the courts of any EU or other major jurisdictions. In addition, the number of potentially available solutions to a determination of such *situs* or location means that, in all likelihood, different conclusions might be reached by different courts in different jurisdictions.

3.30. The proponents of the *lex situs* and related "location of account" tests argue that they provide an objective and easily ascertainable connecting factor to which third parties might reasonably look to ascertain the law relevant to questions of title. They might also suggest that the country of the *situs* has control over the property that is "located" there and, therefore, the local courts can maintain jurisdiction over any matter, event or circumstance that affects title to the property. These arguments have much force in relation to tangible assets. However, they carry little weight and provide no clear answer where the asset itself is an intangible right in or in relation to underlying securities constituted or evidenced by the credit of securities to a securities account and where:

(a) the securities accounts maintained by or on behalf of a relevant intermediary may be operated, together with securities accounts maintained by or on behalf of other relevant intermediaries, on technical infrastructure that may be located anywhere in the EU or elsewhere;

(b) the underlying securities to which the securities accounts relate may themselves be registered securities or bearer securities, where the register on which the securities are registered or the depository at which the securities are held may be located in any number of different states or territories; and

(c) the relevant intermediaries which use such a common technical platform are likely themselves to be established in different states or territories.

3.31. In the context of intermediated securities and the current state of the law, any one or more of the matters listed in (a) to (c) above (or, indeed, any other matter relevant to the maintenance or operation of the securities accounts) might be identified by an EU (or other) court as establishing the *situs* or location of the securities held with (or the securities account maintained by) the intermediary. A test based on *situs* or "location of account" would not, therefore, provide a clear solution to the issue of which law would govern proprietary issues under a single application model.

3.32. It follows that any intermediary that operates on a common technical platform, with the aim of reducing the costs of cross-border settlement, could not be confident that a single, uniform law would be applied throughout the EU (or elsewhere) to determine proprietary issues affecting the securities accounts maintained with it. In particular, the intermediary and its customers could not be sure that the law which they consider governs such issues would be recognised by a relevant court. Such uncertainty is clearly unattractive to markets. It militates against the development of a single application solution for cross-border trading and settlement activity.

3.33. In contrast, the Hague Securities Convention provides a transparent and objective means to determine the law applicable to such issues. Implementation of the Hague Securities Convention can be seen as removing current impediments to the development of initiatives which will substantially reduce the cost of cross-border securities settlement in the single European market.

4. Responses to arguments against the Hague Securities Convention

(a) The Hague Securities Convention would "re-locate" the *situs* of an intermediated security and would cause uncertainty for established rules of law that rely on *situs*

4.1. The scope of the issues that are governed by the test laid down in Article 4(1) of the Hague Securities Convention is delineated by Article 2(1). It follows, of course, that an issue that does not fall within Article 2(1) will continue to be governed by the law which, in accordance with the applicable principles of private international law, governs that issue.

4.2. The Hague Securities Convention test will replace the *lex situs* or related "location of account" test as being determinative of the law which governs proprietary issues affecting securities credited to a securities account held with a securities intermediary. However, the conflicts test contained in the Hague Securities Convention is itself avowedly <u>not</u> a *situs* or location test. It does not attempt to give content or meaning to the location of a securities account.

4.3. It is possible that a court may be seized of an issue impacting upon securities held with an intermediary, but the issue itself might fall outside the scope of Article 2(1). It may also be the case that, in accordance with the principles of private international law applied by that court, the *lex situs* remains the law which is determinative of or relevant to that issue.

4.4. We have already noted that, in the context of intangible assets, the courts have been required to evolve rules which "attribute" a *situs* or location to the asset concerned. Those rules are likely to be guided by a number of different policy issues which are relevant to an effective determination of the specific issue before the court.

4.5. For example, a forum court may be asked to exercise its *in personam* jurisdiction to enforce a recognised judgment debt against the account-holder's interest as against the intermediary (e.g. by way of attachment or garnishment). Let us assume that under the conflict of laws rules applied by the forum court: (a) such jurisdiction may only be exercised if the *situs* of the interest is in the same state or territory as the court; and (b) an interest's *situs*, in the context of the exercise of the court's personal jurisdiction, coincides with the place where the interest is properly recoverable or can be enforced by the account-holder as against the intermediary.

4.6. This would be a sensible rule of private international law from a policy perspective. It would ensure that the intermediary obtains a good discharge of its obligations to the account-holder, in relation to securities credited to the securities account, by performance of those obligations in favour of the judgment creditor pursuant to the court's order. The *lex situs* would recognise the court order and, therefore, there would be no risk of the intermediary having to perform its contractual obligations twice over – once pursuant to the court order, and once pursuant to the account agreement under the law of the place where the interest is properly enforceable.

4.7. In such a case, if the intermediary is established in the same state or territory as the court (and is, therefore, susceptible to the court's *in personam* jurisdiction) and its performance under the account agreement is properly enforceable in that state or territory, the court will assume and exercise its personal jurisdiction over the intermediary (i.e. by issuing and permitting service of an order of attachment or garnishee on the intermediary).

4.8. This would be the case even if the Hague Securities Convention law is different from the law determined as the *lex situs*. This conclusion is not altered by the fact that the making of an attachment or garnishee order against the intermediary will have proprietary consequences, by reason of its effect as an appropriation of the account-holder's interest for the benefit of the judgment creditor. The *situs* of the account-holder's interest is relevant here to the determination of whether performance by the intermediary, pursuant to the attachment or garnishee order, would be a good discharge of its contractual obligations to the account-holder. This is not an issue specified in Article 2(1) as being governed by the Hague Securities Convention law. The court is not, for example, concerned with the duties of the intermediary to *a person <u>other than</u> the account-holder* within Article 2(1)(e) – on the contrary, it is solely concerned to identify where the intermediary's duties *to the account-holder* are properly enforceable so as to determine whether the law of that place would recognise the intermediary's performance pursuant to the court order as complete performance of those duties. Such matters are outside the scope of the Hague Securities Convention (as expressly recognised by Article 2(3)(a)).

4.9. In short, the Hague Securities Convention says nothing about matters that fall outside its scope. The implementation of the Hague Securities Convention does not, and cannot, alter the continuing validity of the relevant policy considerations determinative of the *situs* of property where: (a) the issue before the court is not an issue within Article 2(1); and (b) (under applicable conflicts principles) the *lex situs* governs or is otherwise relevant to a determination of the issue. The Hague Securities Convention is not capable, therefore, of "re-locating" the *situs* of the rights constituted or evidenced by the credit of securities to a securities account.

(b) Unfairness to small banks when dealing with large banks

4.10. We understand that a further argument raised against ratification of the Hague Securities Convention is the effect it will have on the dealings of small banks with larger, more dominant, banks. The concern is apparently that small banks will be disadvantaged, as large banks will force small banks into agreeing that the securities account relationship between them will be governed by a choice of law unfamiliar to the small bank. This choice of law will be unfair to the small bank, which will not have the extensive legal department the large bank will have in order to be able to fully manage the legal issues arising from the choice of law.

4.11. We do not express any views on the competition aspects that this issue raises. However, we do note that to the extent that this situation raises valid issues in the context of the ratification of the Hague Securities Convention, it is already one faced by small banks in their dealings with larger banks prior to the Hague Securities Convention being ratified. This is a particularly valid point when one bears in mind that the primary focus of the parties to an account agreement, as far as governing law is concerned, will be on the effect of the choice of law on the contractual relationship between them on an on-going basis (and not its proprietary effect as against third parties). Therefore, the decision whether or not to ratify the Hague Securities Convention will have no effect on this issue and will not change the challenges faced by small banks.

(c) "Party autonomy"[10] issues

4.12. It is understood that a number of commentators have expressed concerns that the choice permitted to intermediaries and account holders in Article 4 of the Hague Securities Convention could result in a securities settlement system ("SSS") operating securities accounts subject to different laws. It is suggested that this situation could give rise to uncertainty and systemic risk.

4.13. A question arises as to whether, under the Hague Securities Convention, States have a residual power to restrict the parties' freedom to choose the law applicable to the relevant proprietary issues, where the State or an agency of the State has identified systemic or other regulatory issues consequential upon such a choice. For example, the operation by an SSS of a number of different securities accounts under different laws, chosen by the operator and relevant participants, will result in a loss of fungibility between the securities credited to these different accounts. This loss of fungibility may give rise to issues that a State or its relevant regulatory authority considers detrimental to the stability of the State's financial markets. It has been suggested that Article 4 of the Hague Securities Convention does not merely provide a mechanism for determining the effect of a given choice of law in the parties' account agreement, but obliges signatories to recognise the parties' freedom to choose the law applicable to the relevant proprietary issues. Some may go further and argue that such an obligation at the international level effectively vests in the parties a directly enforceable "right" (whether under public or private law) to choose the law applicable to proprietary issues (referred to as the "party autonomy principle"), and that this right would be enforceable at the domestic level in certain jurisdictions. Such a right, it is claimed, would be one from which national or European law or regulation could not derogate.

4.14. This issue can be illustrated in the European context by considering the provisions of a putative revised Settlement Finality Directive ("SFD"), which would be required following EU ratification of the Hague Securities Convention. One way to address concerns about the operation of different securities accounts under different laws within one "system" would be, in the context of a revised SFD, to include, alongside the current SFD requirements which must be satisfied before a "system" may be designated by a member

[10] See footnote 8 above in relation to this phrase.

state,[11] an additional requirement that the law of that member state must alone govern proprietary issues affecting securities credited to accounts held in that system. However, the question raised by those who are concerned about the scope and effect of the "party autonomy" principle is whether such a requirement would be compatible with the Hague Securities Convention.

4.15. In the view of the FMLC, such a regulatory approach would be compatible with the Hague Securities Convention. The FMLC has formed this view without reaching (or needing to reach) any conclusion on the question as to whether the Hague Securities Convention does in fact oblige signatories to recognise a right in the parties to choose the law which will govern proprietary issues (or provides a directly enforceable right to this effect). Nor does it presuppose any conclusion on the extent to which such an obligation is qualified by the "*ordre public"* exception contained in Article 11 of the Hague Securities Convention. The FMLC recognises that there is a range of interpretations of these Articles and do not seek to express a view on how they would be interpreted should the points be tested. However, an approach, in the domestic or European legal context, that seeks to manage systemic or other risks identified by allocating regulatory consequences to the parties' choice of law does not, the FMLC believes, contravene any party autonomy principle that may exist.

4.16. Thus, in our illustrative example, a revised SFD could ascribe regulatory consequences, such as the unavailability of designation, to a choice made by an operator and its participants of a non-Member State law to govern proprietary issues affecting securities credited to accounts held in their system. Equally, a regulatory authority within a Member State could properly make it a condition to its authorisation or recognition of the operator of an SSS that its "system" should be designated under the SFD, on the basis of the systemic and other regulatory consequences for settlement finality in the SSS caused by a lack of such designation. Such responses, both at the European and domestic level, would be a valid regulatory approach and would not constitute derogation from the party autonomy principle under the Hague Securities Convention (if such exists). Such responses recognise the choice made by the operator of an SSS and its participants. However, as a tool in managing identified systemic and other regulatory consequences of such a choice, the State or the relevant regulatory authority simply makes it a condition to the access of the SSS to a separate and independent public or private law "right" (i.e. designation, authorisation or recognition) that the law of a single member state must govern proprietary issues affecting securities credited to the accounts held in the SSS.

4.17. The force of this argument is apparent when it is remembered that, regardless of the way in which the regulatory consequences of the parties' choices are managed, the consequences for the law governing proprietary issues affecting securities held and transferred through the SSS are exactly the same. The choice of the parties as to the law governing proprietary issues remains valid and enforceable despite the regulatory consequences (i.e. unavailability of designation, authorisation or recognition). So, it cannot be said that the

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11 See Article 2(a) of the Settlement Finality Directive (98/26). A new provision as described would sit alongside the current provision for the arrangement constituting the system to be governed by the law of a member state chosen by the participants.

regulator has deprived the parties of their freedom to choose or of their right to have that choice recognised as the governing law for the proprietary aspects of the account.

4.18. In addition to the legal consideration outlined above, the FMLC thinks it extremely unlikely that any system operator would, in any event, undermine the fungibility of interests in securities *within a single system* by choosing to operate different accounts with different governing laws. However, if a regulatory law, such as a revised SFD, were passed at the European or national level allocating negative regulatory consequences to such an operational arrangement, the SSS, as an intermediary, together with its clients, might still be able to participate in the full range of any right of choice of law autonomy, if the integrated technological facility were restructured so as to allow the intermediary to operate more than one “system” for SFD or other purposes.

4.19. In such circumstances, there would still be single systems operating severally, within the contemplation of the SFD, each with accounts governed by only one governing law, but parallel systems would be available to the operator/intermediary’s clients containing accounts governed by the law of other countries. The Hague Securities Convention makes this possible, in a way that the “location of account” approach does not, precisely because the relevant governing law is divorced from the physical location of the integrated technological facility.

4.20. If an integrated technological facility were to be restructured in this way, there would be significant implications for the intermediary/operator, regulatory implications for each system individually and the need for careful management of inter-systemic dealings to preserve the legal and regulatory integrity of the structure of the integrated technological facility. The FMLC believes that, given these implications, operators would not lightly embark upon the setting up of a structure of this kind.

5. Conclusions

5.1. As has been outlined above, the FMLC considers that there is currently a significant issue in relation to how the law applicable to proprietary issues affecting a securities account is ascertained, which gives rise to uncertainty, and therefore systemic risk, in the cross-border securities markets.

5.2. The uncertainty that currently exists in relation to the law applicable to proprietary aspects of securities held with intermediaries is one that leads to real costs to market participants. At the most basic level, these costs relate to legal fees spent in gaining legal opinions on transactions and security arrangements in the global financial markets. Furthermore, market participants must address the uncertainty they face by making appropriate regulatory capital provisions[12] for their activities that involve securities transactions. Similarly, in their dealings with counterparties, banks will include charges in response to the credit risk they perceive they are taking on. Moreover, in certain circumstances certain lines of business will be shut down, or not pursued at all, if the uncertainty over collateral and related exposures creates unacceptable legal risk or results in regulatory capital requirements too onerous to make the business viable.

5.3. The Hague Securities Convention offers a solution to the issue. This solution has the benefit of providing certainty and universality. The opportunity to achieve a common solution to the issue of the law governing proprietary issues affecting international securities in all major financial jurisdictions around the world is extremely valuable and its loss would be correspondingly damaging.

5.4. The FMLC would be concerned if there was any unnecessary delay in implementing the Hague Securities Convention. The uncertainty, and resulting risk, that exists currently in relation to the question of the applicable law represent a major issue for market participants, which would benefit from being resolved as soon as possible.

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12 As required under the Basel II capital adequacy regime, which has recently been implemented in the European Union by the Capital Requirements Directive (Directive relating to the taking up and pursuit of the business of credit institutions, agreed text of the European Parliament and of the Council dated 18 October 2005). The Basel II regime requires banks to carry more capital to cover unsecured loans than they do for secured loans and will almost certainly see a continued increase in the use of securities as collateral for loans. However, legal uncertainty in cross-border securities transactions will need to be addressed in the regulatory capital provision that a lender makes for a loan secured in this way.

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