28 June 2017

Unit C2 – Financial Markets Infrastructure
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Bruxelles/Brussels
Belgium

Dear Sirs

Consultation document on conflict of laws rules for third party effects of transactions in securities and claims—7 April 2017

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") 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]

The FMLC welcomes the recent publication by the European Commission of a consultation paper on the problems and risks caused by lacunae in the harmonisation of the conflict of laws rules on the proprietary effects of transactions in securities and claims (the "Consultation"). The FMLC wishes to take the opportunity afforded by the Consultation to draw attention to its previous work on: (i) the Hague Convention on the laws applicable to certain rights in respect of securities held with an intermediary (the "**Hague Securities Convention**"); and (ii) the assignment of claims under Article 14 of Regulation 593/2008 of 17 June 2008 on the law applicable to contractual obligations ("**Rome I**").[2]

The need for, and benefits of, the Hague Securities Convention

In a paper offering a *Legal assessment of the arguments relating to the signing of the Hague Securities Convention—the need for, and benefits of, the Hague Securities Convention* published in November 2005 (the "HSC Paper"),[3] the FMLC observes that there is 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. The HSC Paper goes on to conclude that the Hague Securities Convention provides a suitable and effective solution to this issue.

The conclusions reached in the HSC Paper support, therefore—in response to Questions 8, 11 and 12 of the Consultation—overarching reform of the current E.U. rules, and more specifically the view that the E.U. should become party to the Hague Securities Convention. This recommendation is made after an analysis of the limitations arising out of the *status quo*, and of the benefits of the adoption of the Hague Securities Convention.

Analysis of the Status Quo

Section 3(a) of the HSC Paper explores the manner in which the current situation—whereby harmonised conflict of laws rules based on a similar approach of using the Place of the Relevant Intermediary Approach ("PRIMA") as a connecting factor can be found in a number of E.U.

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[1] The Members of the Committee are Lord Walker (Chairman), David Greenwald (Deputy-Chairman), Andrew Bagley, Sir William Blair, Hubert de Vauplane, Simon Dodds, Michael Duncan, Simon Firth, Bradley J Gans, Kate Gibbons, Richard Gray, Mark Kalderon, Sir Robin Knowles, Piers Le Marchant, Sean Martin, Jon May, Sean McGovern, Sinead Meany, Chris Newby, Stephen Parker, Jan Putnis, Barnabas Reynolds, Peter Spires, Sanjev Warna-kula-suriya, Geoffrey Yeowart and Antony Zacaroli. Members act in a purely personal capacity.

[2] The FMLC is also grateful to Kevin Ingram for his help in preparing this response.

[3] FMLC, *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary: Legal assessment of the arguments relating to the signing of the Hague Securities Convention—the need for, and benefits of, the Hague Securities Convention*, available at:

http://web.archive.org/web/20170108031105/http://www.fmlc.org/uploads/2/6/5/8/26584807/58.pdf

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instruments[4]—is a partial approach. The views expressed by the FMLC resonate with Section 3.1.5 of the Consultation, which considers the fragmented legal framework applicable in this area, and have a bearing on Question 7 of the Consultation, which asks respondents about the scale of the difficulties encountered owing to the dispersal of conflict of laws rules in E.U. directives and national laws.

Section 2(b) of the HSC Paper examines the issues associated with establishing the location of the account for the purposes of the PRIMA solution, particularly in the context of the arrangements of a multi-national organisation. This appraisal chimes with Section 3.1.1 of the Consultation, which observes that existing conflict of law rules do not specify where an account is "located" or "maintained", and relates to Question 3 which asks respondents whether they are aware of any situations where it is not clear how to apply E.U. conflict of laws rules, or their application, leads to outcomes that are inconsistent.

Benefits of the Hague Securities Convention

The benefits of implementing the Hague Securities Convention—that is, giving effect to an express agreement on governing law between an account holder and its intermediary with respect to the proprietary effects of securities holdings and transactions, subject only to a "qualifying office" requirement—are identified at Section 3 of the HSC Paper, and include: (i) high *ex ante* certainty; (ii) the introduction of a harmonised, internationally-consistent conflict of laws regime; (iii) the efficiencies which may be gained by referring a portfolio of securities to a single legal system; (iv) consistency as between the proprietary effects of different transactions (e.g. collateral provision and sale); and (v) a potential reduction in administrative burdens and costs (for example, through the creation of common IT platforms for cross-border transactions).

As regards paragraph 3.2.3 of the Consultation, which requests that proposed solutions "consider potential future technological changes", the FMLC notes that further innovations in dematerialisation (for example, in circumstances where data is stored in the cloud), may mean that the PRIMA approach, attributing a *situs* to securities accounts, will become untenable.

In the time since the publication of the HSC Paper in November 2005, it is the FMLC's understanding that the application of PRIMA has proven relatively effective within the silos where it is employed (for example, in the context of collateral arrangements). It must be re-emphasised here, however, that the application of PRIMA is not a universal, worldwide solution. It is the view of the FMLC—based on discussions with stakeholders—that the adoption of the Hague Securities Convention by the E.U. would bring significant efficiencies to global cross-border securities transactions through its promotion of a global solution.[5] Finally, the FMLC observes that the Hague Securities Convention could be supplemented by a regulatory framework (for example, restricting the choice of law) if this were deemed necessary for the protection, say, of certain categories of custody services clients within the E.U.

Third party effects of assignment of claims under Article 14 Rome I

The second topic under consideration in the Consultation is the assignment of claims. Question 26 asks respondents which conflicts of law rule on third party effects of assignment of claims do they favour out of: (i) the law applicable to the contract between assignor and assignee, (ii) the law of the assignor's habitual residence, (iii) the law governing the assigned claim, and (iv) other solution(s) as specified by the respondent.

This question has been addressed by the FMLC and Secretariat staff on a number of previous occasions, including in a paper published in March 2010 entitled *European Commission Review of Article 14: Assignment* (the "Article 14 Paper").[6] The Article 14 Paper favours the law governing

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4 See Directive 98/26/EC on settlement finality in payment and securities settlement systems (the "Settlement Finality Directive"), Directive 2002/47/EC on financial collateral arrangements (the "Financial Collateral Directive"), and Directive 2001/24/EC (the "Winding-up Directive").

5 The Hague Securities Convention was effective as of 1 April 2017, and has been ratified by the United States of America, Switzerland and Mauritius.

6 FMLC, *European Commission Review of Article 14: Assignment; Response to the November 2009 Ministry of Justice Discussion Paper on the effectiveness of an assignment or subrogation of a claim against third parties*, available at: http://web.archive.org/web/20150921102541/http://www.fmlc.org/uploads/2/6/5/8/26584807/137.pdf

the assigned claim, for the following reasons, among others: (i) alignment with the principle of party autonomy; (ii) its ability to guarantee consistent outcomes as between competing assignments of the same asset; (iii) the ability of the underlying debtor to identify the person entitled to lay claim to the debt in priority to other assignees, which is observed to be of consequence; and (iv) the potential for lower transaction costs.

Recognising that some Member States will not accept the exclusive application of the law of the underlying claim, the Article 14 Paper acknowledges that carve outs in respect of factoring and certain consumer transactions—where instead the law of the assignor's habitual residence is substituted—may be a necessary political compromise. The FMLC rejects, however, arguments that a similar carve out should exist for securitisations. In the case of securitisations involving more traditional asset classes, such as credit cards and residential mortgages, asset pools are typically geographically homogenous and the law of the assigned claim will be aligned with the law of the real estate and of the debtor's residence for regulatory and practical reasons. In securitisations involving receivables, stakeholders give the FMLC to understand that—in practice—the required levels of due diligence on questions relating to enforcement and priority will encompass the due diligence necessary to establish the law of the assigned claim.

In 2001, the Court of Appeal made it clear that, as far as the common law rules on conflicts of law are concerned, the law of the assigned claim is the correct approach to the third party effects of transactions in claims.[7] The FMLC is well placed to observe the continuing efficacy of this solution for the wholesale financial markets. In that context, the FMLC notes the following points:

a) the use of this connecting factor helps to minimise fraud risk by ensuring that the entitlement of an earlier-in-time assignee will not be subject to the application of a new and unpredictable system of law prioritising the entitlement of a later-in-time assignee (for example, because of notarisation requirements);

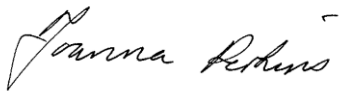
b) where the same law governs effectiveness against the debtor and effectiveness against third parties, there is reduced scope for legal uncertainty which might otherwise arise given the potential for alternative characterisations of a legal issue before a court;

c) it may prove difficult to obtain a clean legal opinion providing comfort as to the location of the habitual residence of an assignor, as this is a question of fact and not law; and

d) where assignors are tied to the law of their habitual residence, requirements such as notarisation and registration imposed by the law of their habitual residence for the purpose of establishing the priority of the assignee's title may create a "drag" on the transaction, particularly in the case of bulk assignments, and disadvantage the assignor. Potentially, this has the result that assignor-originators in different jurisdictions experience an uneven playing field in securing funding for their assets.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours faithfully,



Joanna Perkins
FMLC Chief Executive

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[7] See *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC* and others [2001] EWCA Civ 68, [2001] QB 825.