COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 03.07.2006
SEC(2006) 910

COMMISSION STAFF WORKING DOCUMENT

Legal assessment of certain aspects of the Hague Securities Convention

EN EN

COMMISSION STAFF WORKING DOCUMENT

Legal assessment of certain aspects of the Hague Securities Convention

Table of Contents

Executive Summary

Legal assessment of certain aspects of the Hague Securities Convention

On 15 December 2003, the Commission submitted to the Council a proposal for a Council Decision concerning the signing of the 2002 Hague Securities Convention. The Convention establishes a conflict of law regime which states that the law applicable to holdings of securities is the one named in the account agreement with the relevant intermediary. This differs from the regime which is currently applied in the European Community where the law applicable to holdings of securities is determined by the location of the account.

It is this switch from one formula to another that has prompted a wide-ranging debate about the merits of adopting the Convention. On 23 June 2005, the Council asked the Commission to assess four legal issues that arose in the course of this debate, namely: (1) scope of application, (2) extent of third-party rights, (3) consequences for substantive and public law and (4) impact of the diversity of laws on settlement systems and prudential regimes.

Drawing from a wide range of materials and discussions with Member States, the ECB and other interested parties, the Commission services have arrived at the following findings, set out in Chapter 3:

<u>Scope of application:</u> it appears that the scope of the Convention would not give rise to any significant difficulty or uncertainty in relation to the existing framework of Community legislation.

<u>Third party rights:</u> it appears that, although the Convention will alter the position of third parties, it will not do so significantly.

<u>Substantive and public law:</u> while the Convention has no effect on existing or future rules of substantive law, further integration of substantive law is needed and the work of the Legal Certainty Group remains of utmost importance.

<u>Diversity of laws in a securities settlement system:</u> the Convention might allow securities settlement systems within the SFD to use more than one Convention law. This would threaten the stability of the financial system.

On the basis of these findings, the Commission services remain convinced that adoption of the Convention would be in the best interest of the Community. In order to ensure systemic stability, there should an additional eligibility criterion in Article 2 SFD, as set out in Option 2.

Further, the Commission services recommend that the Convention should be signed after or with at least two of its main trading partners, the USA included.

1. INTRODUCTION

1.1. The law applicable to securities

In all financial markets, it is necessary to have legal certainty about who has what rights over securities. This includes certainty about which law determines those rights. In a market where cross-border activity is a prominent characteristic, this requires that the rules for establishing which law that is must be the same on both sides of the border. Anything less, and there is the possibility of a conflict between one country's rules and the other's. This is the issue that the Hague Convention is intended to address.

The Convention deals with securities that are held on an account with an intermediary, which is the dominant method of holding securities in the EU, also called book-entry securities, or indirectly-held securities.

There are some situations in the EU where no conflict between one Member State's rules and those of another can arise: essentially, where securities are used as collateral within the banking sector. For these situations, Community rules require that the law which determines rights in securities is that of the Member State in which the securities account is located. At this stage in the development of the EU's securities markets and infrastructure, the Community rule has not been further specified. Some have argued that the rule is hard to apply, in that location in the physical sense is an attribute not easily reconciled with records that are maintained electronically by firms which operate as far as possible without regard to national borders.

In other cases, essentially those that concern rights in securities that do not relate to the use of those securities as collateral, there is no common approach across the EU, and the requisite level of legal certainty has not yet been achieved. This legal uncertainty is a current problem for the EU, which needs to be solved. The question is how.

And, if it were correct that the application of the 'location of the account' formula raises problems in some cases where the securities are being used as collateral, here too there would be a need for the EU rule to evolve. In practice, the Commission has not seen any evidence of such problems arising. But, as with any potential issue relating to the stability of the financial sector, it is appropriate to address problems before they materialise.

The Convention, if adopted, would cover all circumstances where securities are held through an intermediary, and would provide legal certainty about who has what rights over those securities. This is essentially the same issue that is already addressed by Community law in the limited circumstances of collateral transactions in the banking sector, but it is based on a new and different formula. Where the Community acquis uses a test based on the location of a securities account, the Convention uses a test based on the law specified in the contractual agreement between the account holder and the intermediary.

Both tests aim to capture the idea that the intermediary should in some way be the focus of the account holder's legal rights. And in most cases both tests will lead to the same result. Nonetheless, it is this switch from one formula to another that has prompted a wide-ranging debate about the merits of adopting the Convention. In June 2005 the Council asked the Commission to assess four legal issues that arose in the course of its debate, and the purpose of this paper is to provide that assessment.

The assessment has been conducted by the Commission services, drawing for that purpose on a wide range of materials from and discussions with Member States, the ECB, and other interested parties.

The meaning of the Convention is not always crystal clear. This is a common feature of international law, and reflects compromises reached during its negotiation. The formal Explanatory Report elucidates the meaning in most cases and the two must be read together[1].

1.2. The four issues to be assessed

The issues the Council asked the Commission to assess are as follows.

Scope of application: this is how the Convention would fit into the EU's legal framework, whether it is unclear and whether its effect can be modified at the EU or Member State level.

Third party rights: this is whether third parties would be prejudiced as a result of the adoption of the Convention. Concretely, it is whether under existing rules a third party has legal certainty as to the law applicable to another's securities portfolio which would be destroyed if the Convention were adopted.

Substantive and public law: this is whether the Convention would jeopardise existing rules that apply to the EU securities markets and whether it is sensible to unify the EU conflicts of laws regime without doing the same to the EU substantive law regime. Concretely, it is whether an obligation to report a suspicion about a securities trade, for example, would be overridden by the use under the Convention of a non-EU law.

Diversity of laws in a securities settlement system (SSS) and impact on prudential regimes: this is whether the Convention would jeopardise the stability of a SSS. Concretely, it is whether an SSS and its members could use a variety of laws, which could destroy the commonality needed for the operation of settlement with the system.

2. OBJECTIVES

2.1. What the EU's securities market require

It is necessary to identify the main characteristics that all those involved in the EU securities markets may expect from the law that concerns the issue under discussion.

Those characteristics are:

Legal certainty about which law applies. This necessitates that the rule for determining the applicable law be identical in all Member States. If it is not, the possibility arises that the two Member States on each side of the border in a cross-border transaction will apply different laws to the same situation. This would create legal uncertainty, potential instability, and is unacceptable.

1 For more information see website Hague Conference on Private International Law: www.hcch.net. The explanatory report is only available in a commercial edition.

International validity of EU rules. This means that the EU's main global partners must give legal recognition to the EU rules. In effect, this is the same as the first characteristic, but on a wider scale: if the USA, for example, is the country on the other side of the border in a cross-border transaction, and the USA state in question has conflicts-of-law rules that differ (i.e. conflict) with those of the EU Member State, the same legal uncertainty arises, with the same consequences.

Law that fits EU securities markets practice and is flexible. EU securities markets are in a state of transition to a comprehensively single market. Law should accommodate the securities markets both as they are and as they are set to become. It may also be noted that, in general, use of a diversity of laws is likely to increase fragmentation of markets, and use of fewer laws to increase integration.

It has also been a strand in the debates whether the Hague Convention would provide a regime that encourages competition in financial markets. This does not directly relate to the conflict of laws, and falls outside the subject of this legal assessment.

2.2. Current EU regime

Three Community legal acts lay down a rule to determine the law by which questions about who has what rights over securities are to be answered. These rules in the acquis differ slightly in phrasing, but are based on the same formula: the law is that of the Member State (or in some cases third country) in which the securities account that records the existence of those rights is located.

The relevant provisions are:

Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (SFD)[2]

Article 9(2): "Where securities (including rights in securities) are provided as collateral security to participants and/or central banks of the Member States or the future European central bank as described in paragraph 1, and their right (or that of any nominee, agent or third party acting on their behalf) with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities shall be governed by the law of that Member State."

Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (WUD)[3]

Article 24: "Lex rei sitae - The enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralised deposit system held or located in a Member State shall

2 OJ L 166, 11.06.1998 p. 45-50.

3 OJ L 125, 05.05.2001 p. 15-23.

be governed by the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located."

Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (FCD)[4]

Article 9(1): "Any question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country."

In the SFD and WUD the reference is to the law of the place where the account is located; in the FCD, it is to the law of the place where the account is maintained. This difference of wording should not be seen as a difference in substance. It reflects recognition when passing the FCD that the EU securities markets had evolved in way that allowed for a more suitable expression - the place where the account is maintained - to be used to describe the same formula. In the WUD the location of the account formula applies to all rights, whether or not related to collateral, but only when they belong to a credit institution.

It may be noted that both the SFD and the FCD are subject to contemporary review by the Commission. On 16 May 2006, the Commission invited interested parties to comment on its evaluation report of the SFD of 15 December 2005. And work towards an evaluation of the FCD as required by its Article 10 has been started, with the issue in January 2006 to Member States and interested parties of a detailed questionnaire. The papers for these exercises may be found on the Commission's website[5].

2.3. The Hague Securities Convention

The Hague Securities Convention is intended to establish a rule that would apply across the major securities markets of the world to determine the law applicable to certain issues in respect of the holding, transfer and collateralisation of securities credited to a securities account held with an intermediary in an international context. The first recital in the preamble of the Convention describes its motivation as the "*practical need in a large and growing global financial market to provide legal certainty and predictability as to the law applicable to securities that are now commonly held through clearing and settlement systems or other intermediaries*".

The heart of the Convention's regime is laid down in Article 4(1), according to which the law applicable to the issues covered by the Convention is the law in force in the State that the relevant intermediary and the account holder have expressly agreed as governing their account agreement, or the law of the State that this agreement expressly provides as applicable to these issues. This primary rule is subject to a so-called 'reality test': the Convention requires the relevant intermediary to have, at the time of the agreement, an office

4 OJ L 168, 27.06.2002 p. 43-50.

5 www.europa.eu./comm/internal_market/financial-markets/ SFD-report,COM(2005) 657 final/2,27.3.2006.

in that State which is engaged in a business or other regular activity of maintaining securities accounts.

The Convention sets out three fall-back rules to determine the applicable law where the parties to the account agreement have not expressly agreed one. These are, in their prescribed order of priority: the law of the jurisdiction of the office expressed in the account agreement as that through which the intermediary entered into the agreement; the jurisdiction of incorporation of the intermediary; its principal place of business.

The Hague Securities Convention thus proposes a formula that differs from the one that appears in the acquis. The adoption of the Hague Convention would therefore require adaptation of existing Community law. This arises where the formula currently found in the acquis is used for matters that fall within the scope of Convention: the SFD, FCD and WUD. It should be added that, with regard to the FCD, the Council was aware that the approach in the Convention and existing Community law could prove to be incompatible: the negotiations in the Hague for the Convention and the negotiations in Brussels concerning the proposal for the FCD were running most of the time in parallel, with the first feeding into the second. The Council found it impossible to postpone the passing of the Directive until the discussions in the Hague Conference had been completed, and consequently noted in the Common Position that "… *when the Conference has been finalised, Article 9 may have to be reviewed in the light of the outcome of the Convention*"[6].

2.4. Third countries

53 members of the Hague Conference initialled the text of the Convention. Nonetheless, at the time of writing none has signed, let alone ratified, the Convention. As with every international agreement, the success of the Convention depends on the number of countries that become party to it. In the case of this Convention, there will be no real value for the EU in adopting the Convention unless the bulk of the other countries that together represent the global securities markets also adopt it. Accordingly, signature by the European Community and its Member States should take place only after at least two other major players (including most notably the USA) in those markets have also signed, or at a joint signing ceremony.

3. APPRAISAL OF THE FOUR LEGAL ISSUES

3.1. Scope

Scope of application: how would the Convention fit into the EU's legal framework, is it unclear and can its effect be modified at the EU or Member State level?

3.1.1. Personal and material scope

The Convention aims for a uniform global conflict of laws regime applicable to proprietary rights arising in relation to securities held with an intermediary.

6 Common Position (EC) No 32/2002 adopted by the Council on 5 March 2002 with a view to adopting Directive 2002/…/EC …..on financial collateral arrangements, OJ C119E, p. 25.

In personal scope, the Convention covers all relationships where securities are held on accounts for others, as long as the account provider is acting in the course of a business or other regular activity. This is wider than the Community measures, which are do not cover individuals.

In material scope, Article 2 of the Convention sets out an exhaustive list of issues to which the Convention applies. This is wider than Community measures, which deal in essence only with securities that are being used as collateral in the banking sector.

Thus, in the EU currently, there is potential for mismatch between the rule applicable under the acquis to securities used as collateral in the banking sector, and the rule applicable under domestic law to the operations by which the collateral provider came into possession of the securities before using them as collateral. The Convention would address this, as would any extension at Community level of current EU rules to all dealings in securities.

3.1.2. Clarity

First, it has been argued that the Convention is not clear as to what law applies when a transaction in securities involves a transfer by book-entries from an account governed by one Convention law to an account governed by another, under circumstances where a priorities dispute arises between the two account holders. If, each under their Convention law, both would be entitled, to which account holder does the Convention accord priority?

It must first be noted that it is an unfortunate lapse of drafting that the Convention text itself does not have a normative provision expressly addressing this crucial issue. However, it must also be noted that, for the reasons set out at some length in the Explanatory Report (see notably paragraphs 4-43 to 4-51) there is, on construing the Convention, no doubt on this issue: priority goes to the transferee. Finally, it may be noted that, although priority is dealt with in the manner stated, it is entirely possible that the transferor may retain a claim in respect of securities against its own intermediary.

Secondly, it is said that certain terms, although defined, are so vague as to create unacceptable uncertainty. Focus in particular has been given to the definition of 'securities' and cognate terms that make reference to it. Article 1(1)(a) provides that, *"... "securities" means any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein"*. It has also been argued that the definition of 'securities account' is too loose. Article 1(1)(b) provides that it means, "*… an account maintained by an intermediary to which securities may be credited or debited*." It has been argued that this definition requires for its efficacy a further definition of an account.

The Explanatory Report justifies the broad approach taken, emphasising an intention to avoid a list of included or excluded instruments which might become out of date because of developments in market practice. The interpretation provisions of the Convention strike an appropriate balance between exhaustive definitions and the need to use terms that are flexible enough to apply to different instruments and markets and to cope with new developments. Further, any confusion that might otherwise have surrounded borderline issues will be alleviated by the fact that operating securities accounts is a highly regulated activity.

3.1.3. Legal systems in which those who hold securities indirectly have property rights and those where they do not

Throughout the debates concerning the Convention, reference has been made by a wide range of commentators to a distinction between legal systems in which those who hold securities through an intermediary have property rights and ones where they do not. The former is generally treated as being preferable to the latter. The distinction is drawn by those seeking to argue that investors may feel obliged to agree in their contracts to a Convention law that would convert property rights into non-property rights.

As to this, it may be remarked, first, that the work of the Commission's Legal Certainty Group has shown that no legal system in which those who hold securities through an intermediary have no property rights exists within the EU. Secondly, and contrary to what the Commission has been told on a number of occasions, New York law does confer property rights on those who hold securities indirectly. Finally, if the consequences of the application of such a law (if one were found to exist) were against the public policy of a State, then not only would adverse regulatory consequences doubtless be assigned to account agreements in which its use had been agreed but also the provisions of Article 11 of the Convention might apply.

3.2. Extent of third party rights

Third party rights: this is whether third parties would be prejudiced as a result of the adoption of the Convention. Concretely, it is whether under existing rules a third party has legal certainty as to the law applicable to another's securities portfolio which would be destroyed if the Convention were adopted.

This issue is essentially whether the Convention would have an effect on the rights of third parties that is unfair, unpredictable, or inconvenient as compared to the current EU regime. In particular, it has been argued that the choice of applicable law made by an account holder and its intermediary would disadvantage third parties in that they would not know of it or, if they did know of it, would find it inconvenient.

3.2.1. Transparency

Determination of law by specification within the contract of an account holder and its intermediary will result in the applicable law not being easy to discover in some cases. And this may be compared with the current position, whereby the law is often ascertainable from known facts that do not require further enquiry. (Of course, the law determined in the contract will nonetheless be objectively established: its identity will not usually be automatically available to third parties, but that does not mean it is uncertain.) However, it appears that the likely disadvantages that determination of law by specification within the contract may bring will not be materially significant. In this context it is also to be noted that the existence of a collateral interest over securities under the FCD is also often not automatically known by third parties (Article 3(1) of the FCD prohibits requirements that collateral "be dependent on the performance of any formal act" such as giving it publicity).

In considering further this issue, it is convenient to separate third parties that have or propose to have a relevant commercial arrangement, and those that do not.

Currently, third parties seeking to gain an interest in securities by agreement, for example by purchase or by taking a collateral interest, already need to obtain information about the existence of a securities account, its location, and the securities held through it. Under the Convention, the third party will also want to know the Convention law. As the co-operation of the account holder or intermediary is already necessary, the need to obtain this additional piece of information will not constitute a significant change. And it is likely that the parties to a collateral arrangement will ensure that it gives the collateral taker a level of control sufficient to prevent the applicable law being changed without its consent. For third parties of this kind, who will communicate with the account holder in advance of any dealing, there can be no materially significant difficulty.

However, other third parties may have had no prior dealing with the account holder as such: typically, these will be creditors seeking through a court process to attach securities for the purpose of enforcing a debt. In order to attach securities, a creditor generally needs to establish the existence of a holding of securities and the jurisdiction to which it is subject. The Convention will not alter this. To establish the existence of a holding normally requires the co-operation of the account holder or the intermediary. It has been said that that rules of confidentiality would hinder this process, preventing intermediaries from disclosing the law chosen. This may well be true in some cases. However, the same rules of confidentiality currently prohibit the release of the information necessary under existing law, such as the identity of the account holder and the details of his holding. For this reason court processes exist that can be used to compel the release of information. It has not been suggested that these processes do not extend to information about the Convention law. Thus the necessity to obtain one point of additional information (that is, the applicable law) would not materially aggravate the existing position of an attachment creditor.

It may be mentioned in this context that the Community and its Member States could, and probably should, make a formal declaration under Article 16 of the Convention. This would have the effect that a provision (of which there are said to be many) in a pre-convention account agreement as to the country where an account is located or maintained would be treated as determining that the law of that country governs the Convention issues. This was included in the Convention in order to avoid the need to change all existing account agreements after ratification of the Convention.

One suggestion made to the Commission has been that diagnostic numbers should be used for securities accounts in the same way as IBAN numbers are currently used for cash accounts. If such numbers were to be developed, it might be sensible for them to include a diagnostic component that indicated the law expressly agreed upon in the account agreement under the Convention. This would further diminish any lack of transparency, and the Commission welcomes the industry's current exploration of this idea within its 'DENISA' numbers initiative (Diagnostic European Numbers for International Securities Accounts).

3.2.2. Subsequent changes of applicable law

As a connected issue, it has been alleged that secured creditors may be disadvantaged by any subsequent changes to the choice of applicable law made without their consent. However, fears of this kind are unfounded, since the pre-acquired rights of secured creditors are preserved by Article 7. The effect of Article 7 is that rights created under the Convention law may not be restricted or swept aside when that law changes by agreement of the parties. Their agreement to change the Convention law may not be imposed on a third party that had acted in reliance on the first account agreement and the Convention law determined by it.

3.2.3. Court proceedings

All creditors, whether secured or unsecured, may need to issue court proceedings for attachment or enforcement. As the Convention does not alter rules of jurisdiction or procedure, the court to be used would be unchanged. That court might be required by the Convention to apply a foreign law. This practice is common already in the EU, and will increase as cross-border securities activity increases. The application of foreign law in cross-border cases is an unavoidable by-product of market integration, and courts have established procedures for coping with such a situation.

3.3. Consequences on substantive and public law

Substantive law: this is whether the Convention would jeopardise existing rules that apply to the EU securities markets and whether it is sensible to make the EU conflicts of laws regime uniform without doing the same to the EU substantive law regime. Concretely, it is whether an obligation to report a suspicion about a securities trade, for example, would be overridden by the use under the Convention of a non-EU law.

In introducing the assessment of this issue it must first be remarked that the Convention does not fix the location of securities or of a securities account. It fixes the law applicable to them for the matters contained within Article 2(1) of the Convention. In consequence, any rule of law that depends on the location of securities or of a securities account for other purposes remains wholly unaffected by the Convention, as does the location itself of securities and of securities accounts (except in the purely hypothetical case where, in an inversion of the norm, location is determined by applicable law).

It should also be noted that the Convention is clearly not intended to affect or provide substantive law applicable to securities held with an intermediary. As the Explanatory Report says (at paragraph 2-1), the Convention "… *has no effect on existing or future rules of substantive law*".

3.3.1. Company law

This issue is essentially that if the law governing corporate actions (such as exercise of voting rights or payment of dividends) differs from the Convention law as agreed upon by an investor, this will cause difficulties.

By way of examples of such difficulties, it has been suggested that an issuer will be prevented from knowing who holds its securities, or that a situation could arise where, in order properly to determine which persons are entitled to exercise rights arising from securities, an issuer would need to require each claimant to prove the legal means by which the entitlement is vested in him, including the relevant account agreement, and that this would add to complexity and expense. Furthermore, it is argued that the legal character of securities and the rights arising from them should be determined by reference to the law under which they were issued.

It must be stated that the Convention expressly provides that it does not determine the law applicable to the rights and duties of an issuer of securities, whether in relation to the holder of securities or any other person. This exclusion encompasses the duties of the issuer with respect to all corporate actions, including voting rights and dividends. These matters would continue to be subject to the applicable corporate law, and would not be affected by the ratification of the Convention.

Finally, it is argued that adoption of the Convention could complicate implementation of the Commission's Action Plan for Modernisation of Company Law and Enhancement of Corporate Governance in the EU, in which shareholder rights play an important role. This fear does not seem realistic: the Commission's proposal for a Directive on the exercise of shareholders' voting rights[7] would, if adopted, require Member States to alter the rights and duties of an issuer of securities in relation to certain corporate actions, including voting rights, regardless of the law applicable to holdings in securities determined by the Convention.

3.3.2. Insolvency law

It has been suggested that the Convention would affect the Regulation 1346/2000/EC on Insolvency Proceedings[8], the Directive on the Reorganisation and Winding up of Credit Institutions (see footnote 3) and the Directive 2001/17/EC on the Reorganisation and Winding-up of Insurance Undertakings[9]. These instruments are all based on the principle that an insolvency proceeding opened in one EU State does not affect rights *in rem* over assets in other EU States. Consequently, in principle it is important to determine in which EU State an asset is located, and which law determines whether someone has a right *in rem* over it.

As to the question of the location of an asset, this is neither governed nor affected by the Convention. In this respect the Convention would not affect present EU rules. As to the second question - which law applies to determine whether someone has a right *in rem* over securities held in an account - the Convention applies. For example, under the Convention, the question whether a person has a perfected pledge over an account held by a debtor who is now in insolvency proceedings, would be determined not by the law of the state where the account is maintained, but instead by the law applicable according to the Convention. However, the Convention would not change the EU rules on insolvency proceedings which establish that an insolvency proceeding opened in one EU State does not affect rights *in rem* over assets located in another. Accordingly, the Convention would not require any modification of the relevant EU provisions.

Indeed, the Convention expressly preserves substantive and procedural insolvency rules. It does not affect the determination of the law applicable to insolvency proceedings (see Article 8(2)), save to the very limited extent specified in Article 8(1). Article 8(2) clearly states that nothing in the Convention affects the application of insolvency rules including rules on the ranking of categories of claims. Thus, for example, any question as to whether investors or

---

7 Commission's proposal for a Directive of the European Parliament and of the Council on the cross-border exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC, COM(2005) 685 final, 5.1.2006.

8 OJ L160, 30.6.2000 p. 1-18.

9 OJ L110/28, 20.4.2001, p.28-39.

creditors are entitled to securities held by their intermediary in the case of the intermediary's insolvency, and an investor's relative position against the creditors, or against other investors, are questions of insolvency ranking governed by the applicable insolvency law and not by the Convention law. The Convention law merely determines the existence and characterisation of an investor's rights and not the relative position of the investor against other creditors and investors.

It might be the case, however, that the insolvency law of the jurisdiction where the intermediary is most likely to be subject to insolvency proceedings may treat investors differently depending on how their rights are characterised under the law governing their account agreements. That is, the nature of a proprietary interest, as determined in accordance with the Convention law, might affect its ranking under the applicable insolvency law. If that is the case, the investor and his intermediary should take this into account when concluding the choice of law agreement.

3.3.3. Anti-money laundering and market abuse law

The concern has been raised that there may be a risk of conflict between reporting duties imposed on EU intermediaries in the areas of money laundering and market abuse and laws preserving the confidentiality of client's affairs arising under a non-EU law chosen as the Convention law.

It is argued, first, that the Convention itself invokes the confidentiality rules of the Convention law, in that it covers "*the legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account*" (Article 2, paragraph (1)(a)). However, this provision must be read alongside Article 3(a), which provides that the Convention does not determine the law applicable to rights and duties arising "*… to the extent that such rights and duties are purely contractual or otherwise purely personal*." A right to confidentiality, and any duty to depart from confidentiality on the part of the intermediary, are not property rights. They are "purely personal", and unaffected by the Convention. Transaction reporting requirements do not fall within the issues set out in the Convention. The choice of the law of a non-EU state will therefore have no impact on the transaction reporting obligations imposed on an intermediary, an account holder or any other person concerned with securities held in the relevant securities account.

It is argued, secondly, that the problem would arise if a law were chosen that imposes confidentiality rules by reference to its application to the proprietary issues that the Convention deals with. It must first be noted that one can disqualify from this hypothesis the law of any country that is itself a party to the Convention. It must also be noted that the presumed problem is based on the hypothesis that a law is chosen that imposes confidentiality rules neither by reference to the identity or location of the parties, nor the location of the securities, nor of a securities account. However, all mechanisms of which the Commission is aware used to fight money laundering are based upon territorial rules, and there is no evidence that laws which would be capable of giving rise to the presumed problem actually exist.

Moreover, the exception for mandatory rules of public policy in the Convention makes it clear that transaction reporting obligations and similar obligations based on public policy requirements would not be affected in any event. If, as the hypothesis would have it, by agreeing that the law of a specified country will apply to a securities account, an intermediary and account holder subject themselves to the banking confidentiality laws of that country, and those laws would conflict with EU reporting obligations, even then this would have no effect on the institution’s reporting requirements. It is possible that an intermediary in such a case would place itself in difficulties under the relevant non-EU banking secrecy laws, but this is a risk to which it can reasonably be expected to have regard in its procedures for identifying and controlling operational risk (and if it did not do so, its supervisors would no doubt take appropriate action).

3.3.4. Tax law

The Convention has no direct effect on the application of tax rules, since these are not among the matters specified in Article 2(1) of the Convention. The only way in which the choice of a law to govern proprietary rights in securities could impact on a tax regime applicable to those securities would be where the tax regime in question was based on the law governing those proprietary rights being of a particular kind. No example of this has been cited, nor is the Commission aware of any such regime. It goes without saying that, if such a regime exists, it would be open to the State in question to modify it.

3.3.5. Collection of statistics by the ECB

The ECB has expressed concern that adoption of the Convention might affect the reporting of cross-border securities transactions and positions that forms part of the ECB regime for the collection of statistics. Currently, financial intermediaries are required to report information about cross-border transactions and positions in securities by euro area residents, irrespective of the law applicable to the securities in question. It does not therefore seem that adoption of the Convention would necessitate any change to the ECB's statistical reporting requirements.

3.3.6. Substantive law reform

Essentially it is argued that adoption of the Convention might compromise the EU work in the area of clearing and settlement, and in particular that of the Commission’s Legal Certainty Group. This Group deals with substantive law and not with private international law. The two are separate, and can be dealt with separately. In fact, the Legal Certainty Group resolved at its first meeting, in January 2005, that it would be able to conduct its work without reliance on any particular rule of private international law.

However, the concern is primarily based on a view that it would be in the interests of the EU for harmonisation of substantive law to precede the adoption of the Convention in order to make the resulting choice between EU laws of nugatory importance (as they would *ex hypothesi* all be the same as each other), or to make all EU laws more competitively attractive in the perceived competition between laws that the Convention would allow. Further, one commentator has argued that integration of substantive law will remove the need for any conflicts rule at all.

In the Commission’s view a conflicts rule is needed in every circumstance where more than one jurisdiction is in play. Even if the substantive regime for holding securities was literally identical in every respect in every EU Member State, a rule would still be necessary to determine the applicable law on an international scale, i.e. in the relation of the EU with third countries. Furthermore, any reforming product of the Legal Certainty Group is very unlikely to be so comprehensive as to make the substantive regime of Member States identical in every respect. It is possible that the product will at its widest be a set of rules harmonizing key features of Member States' law, but even then not conforming to the broader framework of Member State law of which the rules on book-entry securities transactions form part. Clearly a comprehensive unification of property law and related rules is neither feasible nor desirable.

Since parties needing, for example, to document transactions will have to deal with the bulk of the substantive law of the relevant Member State; it will continue to be vitally important to know which law is applicable.

3.4. Impact of diversity of laws

Diversity of laws in a securities settlement system (SSS): this is whether the Convention would jeopardise the stability of an SSS. Concretely, it is whether an SSS and its members could use a variety of laws, which could destroy the commonality needed for the operation of settlement within the system.

This issue is essentially that the Convention might be used to create, perpetuate or exacerbate a diversity of laws applicable to proprietary issues within a securities settlement system, which threatens the commonality needed for the operation of settlement of the securities in the system, and thus systemic stability at large. As for prudential regimes, this issue is essentially that use of an unfamiliar law creates or increases legal risk if the law is of low quality, or misunderstood, or both, thus adding to the burden on industry of managing legal risk, and on the public sector of supervising that management.

3.4.1. Diversity of laws on settlement systems

The core business of a securities settlement system is arranging for the transfer of securities between its members. In order to achieve this, it is necessary that the rules and arrangements for the operation of settlement of securities in the system be common among all members.

The concern has been raised that the Convention may have adverse consequences for the smooth, efficient and sound operation of securities settlement systems, if a diversity of laws applicable to proprietary issues were ever to arise within a system (that is to say, within the arrangements between the system operator and all of its members). If this should happen, the commonality needed for the operation of settlement within the system, and thus systemic stability at large, would be threatened.

It must be noted that the application of a diversity of laws can also be a current risk, inasmuch as the difficulties in identifying the jurisdiction whose law governs the proprietary aspects of securities (whether or not held in a settlement system) - the very difficulties which are the raison d'etre of the Convention - continue to exist.

The SFD reflects the need for commonality, by requiring that system operators seeking designation, and hence a high level of legal protection for their operations, must agree with their members one and only one law to govern the rules for the operation of the system (Article 2 (a)). This restriction to only one law does not, however, extend to the proprietary issues which are covered by the Convention.

It has been widely recognised that the common interest of both the public and the private sectors in smooth operations within systems makes it highly unlikely that any system operator would agree to different Convention laws among its members. Furthermore, there being detailed supervision at the national level of the operation of systems, any agreement to operate accounts governed by different systems of law must first be investigated as to resulting legal risks and there nature must be demonstrated to the relevant supervisor. Designating or supervisory authorities also have the power, if necessary, to compel system operators to make sure that no unacceptable legal or systemic risk can arise from the application of diverse laws, and the ECB has the powers and resources to ensure that the necessary legal evaluation is carried out in relation to systems used for delivery of Eurosystem collateral.

Nonetheless, the risk remains that systems would have the power to allow a diversity of laws and yet remain within the SFD zone of protection. The most suitable way to prevent this risk is discussed in section 4.2 below.

3.4.2. Prudential regimes

The essential concern raised is that the Convention allows intermediaries to decide to specify in an account agreement a Convention law that is unsuitable, either because it is of low quality, or misunderstood, or both. This, it is said, increases legal risk.

It is also said that the Convention would result in a transfer of legal risk. Currently, it is argued, intermediaries that operate internationally are exposed to and required to manage such legal risk as arises from a wide range of laws. By contrast, those which operate domestically are exposed to and required to manage such legal risk as arises from only domestic law. If these latter intermediaries decide to specify in their account agreements one or more non-domestic laws as Convention laws, they will be entering onto unfamiliar ground, and that might in turn increase the burden upon them to manage legal risk.

It would probably also increase the amount of capital reserve they will be required to maintain when the Basel II accord is implemented. Under the Capital Requirements Directive[10] ('CRD'), which received political approval from the European Parliament on 28 September

---

[10] Directive [...], re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. This Directive, in updating the two Directives that it recasts, will give effect to the Basel II rules on capital measurement and capital standards agreed at the G-10 level.

and from the Council on 11 October 2005, banks will be required to hold capital tailored to the type and level of risks to which they are exposed. The CRD does not introduce any specific capital charge for legal risk; however, it introduces and defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk" (Article 4, par. 22).

In considering this issue, one must take account of the fact that legal risk arising from current uncertainty in respect of the location of accounts would be avoided if the Convention were adopted. As discussed in the introduction to this paper, the requisite level of legal certainty has not yet been achieved within the EU. The existing uncertainty is a source of legal risk. The Convention removes this. This improvement in legal certainty will improve the prudential position and assist regulated entities to satisfy requirements to show that their arrangements are legally well founded in all relevant jurisdictions, with the likelihood of a consequential reduction in the amount of regulatory capital that they are required to maintain. Furthermore, the enhanced level of legal certainty provided by the Convention would enable institutions to make a reliable assessment, in advance, of the likely impact of the choice of a particular law on their required levels of regulatory capital, by ensuring that they are thoroughly acquainted with that law.

Finally, as regards relations between participants in a settlement system and their underlying clients, the possibility that these may be governed by a system of law different from that governing the settlement system itself is not created by the Convention, but already exists at present and is inevitable in any cross-border arrangement for the holding of securities with intermediaries. Thus if a participant in a settlement system in State A operates securities accounts for clients at a branch in State B and the determination of the applicable law is based on a territorial principle, the laws of both states A and B will need to be considered by the participant in assessing its legal risks. This is the case at present: the Convention would clarify the position by resolving doubts about the applicable law and would give participants greater flexibility in determining which laws would be relevant. Thus, if anything, the element of choice under the Convention rule assists in the reduction and more effective management of risk, rather than creating or increasing it.

4. THE WAY FORWARD

In this paper so far the four issues specified by the Council have been assessed. In summary, the findings are:

(1) Scope of application: the scope of the Convention would not give rise to any significant difficulty or uncertainty in relation to the existing framework of Community legislation.

(2) Third party rights: although the Convention will alter the position of third parties, it will not do so significantly.

(3) Substantive and public law: while the Convention has no effect on existing or future rules of substantive law, further integration of substantive law is needed and the work of the Legal Certainty Group remains of utmost importance.

(4) Diversity of laws in a securities settlement system: the Convention might allow securities settlement systems within the SFD to use more than one Convention law. This would threaten the stability of the financial system.

The Commission services hope that this legal assessment will help the Council in deciding whether to accept the Commission's proposal (COM (2003) 783) of 15 December 2003 that the Convention should be signed.

As a further contribution to that debate, it may be useful to set out the options that appear to be available to the European Community and its Member States. That is done in the rest of this chapter. Each option is described, and then evaluated against the objectives that were identified in chapter 2 as achieving the characteristics that all those involved in the EU securities markets may expect from the law. Those objectives are: certainty as to which law applies; international validity of EU rules; and law that fits EU market practices, both present and future. In addition, for current purposes, each option is evaluated against whether there would be difficulties posed by the four issues raised by the Council as assessed in this paper.

In its wide ranging discussions with experts and interested parties the Commission services have investigated other possibilities. These have included various options all of which involve to a greater or lesser extent limiting the range of laws from which a Convention law may be established. However, it has become clear that the effectiveness of a choice of Convention law can be limited only in the way provided for in the Convention itself (i.e. that the choice must be express and must satisfy the qualifying office test).

4.1. Adopt the Convention (Option 1)

The European Community and its Member States sign the Convention and upon ratification amend Article 9(2) SFD, Article 24 WUD, and Article 9 (1) FCD so as to remove the 'location of the account' formula on which those provisions are based.

Evaluation

The Convention would bring certainty as to which law applies.

And it would do so internationally.

The focus of the Convention on account agreements correctly matches the trend towards holding securities indirectly. As this trend is driven by increasing dematerialisation and cross-border activity, it is set to continue. The Convention therefore fits market practice both present and future.

The first three issues raised by Council would pose no major difficulties.

As to diversity of laws in a securities settlement system, however, there would be no mechanism to ensure that the protection the SFD confers cannot cover securities settlement systems that allow more than one Convention law.

4.2. Adopt the Convention and amend the SFD definition of a 'system' (Option 2)

As under Option 1, the European Community and its Member States sign the Convention and upon ratification amend Article 9(2) SFD, Article 24 WUD, and Article 9 (1) FCD so as to remove the 'location of the account' formula on which those provisions are based. However, this option would add a further refinement relating to the definition of securities settlement systems set out in article 2 of the SFD.

This paper has highlighted the need to ensure the financial stability of securities settlement systems. This requires that there should not be a diversity of laws applicable to proprietary issues within a system. To achieve this, the eligibility criterion in Article 2 SFD that systems be governed (as to their common rules and standardised arrangements) by one and only one law of a Member State chosen by the participants would be supplemented by an additional criterion, namely that, as regards the proprietary issues falling under the Convention, one and only one law should be expressly chosen by all participants.

It has been suggested that the chosen Convention law should be the law of an EU Member State. This would ensure that the chosen law both includes the Community acquis and automatically keeps pace with its developments. However, it is by no means clear that the freedom of choice of law established by the Convention would allow the Community legislature to restrict that choice to the law of a Community Member State.

Evaluation

The Convention would bring certainty as to which law applies.

And it would do so internationally.

The focus of the Convention on account agreements correctly matches the trend towards holding securities indirectly. As this trend is driven by increasing dematerialisation and cross-border activity, it is set to continue. The Convention therefore fits market practice both present and future.

With this option, none of the four issues raised by the Council would pose any major difficulties. This is because the fourth such issue, diversity of laws in securities settlements systems, would be avoided as it would not be possible for a system to be eligible for designation under the SFD unless only one Convention law is used.

If the parties were permitted to select any (one) law, there would be very little risk that this additional SFD eligibility criterion would offend against the free choice of law that the Convention confers. However, an additional requirement that the selected law be that of a Community Member State would raise doubts as to its compatibility with Article 4 of the Convention.

It was noted at section 3.4.1 above that the common interest of both the public and the private sectors in smooth operations within systems makes it highly unlikely that any system operator would in fact agree to different Convention laws among its members. Nonetheless, matters of systemic stability require the utmost prudence. And a number of commentators have emphasised this. Since there can be no absolute guarantee that means of regulatory control would be enough categorically to prevent systemic risk, it is advisable to ensure that the protection the SFD confers cannot cover securities settlement systems that allow more than one Convention law.

In discussing this Option, it has also been considered whether the threat of a diversity of laws could be avoided by means of requiring systems that are within the SFD to be made the subject of a declaration under Article 1(5) of the Convention. This however would not achieve a satisfactory result, as the declaration power within Article 1(5) relates only to certain types of system (those where the accounts are the records of the issuer or other records which constitute a primary record of entitlement), and the power is conferred on the Contracting State under whose law securities, rather than the system itself, are constituted. More importantly, such an approach would deny the legal certainty that the Convention will bring to the very participants in financial markets - securities settlement systems - that are likely to benefit from it the most.

4.3. Reject the Convention, extend the use of the 'location of the account' formula, and re-open the negotiations (Option 3)

The European Community and its Member States would not sign the Convention, and would instead build upon the current ‘location of the account’ rule by extending it to all uses of securities. It will be necessary to examine whether such an extension, or evolution in securities market practice, or both, would justify providing specification of exactly how the rule should be applied, to ensure that it is treated in the same way in all Member States. Further, it would be sensible to use the Lamfalussy-style comitology procedure to allow for the given specification to be changed, if changes in market practice were so to require.

Evaluation

To the extent that within the EU there is legal uncertainty and inflexibility in the face of developments in market practice, both could be addressed at the level of Community law. However, the main problem is that this option would not provide an international solution, so uncertainty as to the applicable law will persist in the case of proprietary issues with a third country dimension. While Community law may be able to provide certainty as to which law applies when all aspects of a dealing in securities have their origin in different countries within the EU, it would still be unclear which law applies in a case where any aspects are attached to countries outside the EU.

In order to achieve legal certainty internationally, negotiations with third countries would have to be re-opened.

The preceding analysis is summarised in the following table.

Objectives	Option1: adopt the Convention	Option 2: Adopt the Convention and amend SFD definition of a 'system'	Option 3: No Convention, extend location of account
1 Provide legal certainty within the EU	✓	✓	✓
No problem as to scope	✓	✓	✓
No problem as to third party rights	✓	✓	✓
No problem as to substantive law	✓	✓	✓
No problem as to diversity of laws in a securities settlement system	X	✓	✓
2. International validity of EU rules	✓	✓	X
3. Law that fits EU markets:	✓	✓	✓

5. CONCLUSION

Within the European Community there is a harmonised approach to conflicts of law for some limited aspects of the securities markets, based on the 'location of account' formula as it appears in the SFD, the FCD and the WUD. Nonetheless, at least for rights in securities that do not relate primarily to the use of those securities as collateral in the banking sector, the requisite level of legal certainty has not yet been achieved within the EU. This legal uncertainty is a current problem for the EU, which needs to be solved.

Adoption of the Convention is the best way to address this problem, as it would provide a comprehensive regime covering all circumstances where securities are held through an intermediary. The Convention is the only way to achieve legal certainty at a global level.

The first three of the four issues raised by the Council do not pose any major difficulties. For the fourth issue, diversity of laws within EU settlement systems, the Commission suggests that there should be an additional eligibility criterion in Article 2 SFD, as set out in Option 2 above. This is in order to ensure systemic stability within the EU.