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CONFLICT OF LAWS RULES

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A. Introduction

10.01 The vast majority of transactions in securities held with an intermediary take place in an international context. The notion of internationality is therefore defined in section B. The Hague Convention of 5 July 2006 on the Law Applicable to Certain

Rights in Respect of Securities Held with an Intermediary ('the Hague Securities Convention' or HSC) has been drafted to clarify the law applicable to a situation involving intermediated securities. After a brief résumé of the history of the HSC in section C, section D defines the scope of the Convention's application. Section E examines the choice of law rule set out in the HSC, while section F deals with the other rules that may be taken into consideration in order to find the applicable law. Section G discusses the factors that are not relevant to determining the applicable law. Section H deals with the protection of third-party rights, which may be compromised in case of a change of law or the opening of insolvency proceedings. Section I examines the relationships between the HSC and the UNIDROIT Convention of 9 October 2009 on Substantive Rules for Intermediated Securities ('the Geneva Securities Convention' or GSC). Finally, section J analyses the main problems raised by the HSC from a European perspective, and possible ways forward.

B. Internationality of a Situation Involving Intermediated Securities

10.02 The HSC applies when a situation involving intermediated securities is international. The Convention refers to an autonomous notion of internationality by stating that there is an international situation in all cases that involve 'a choice between the laws of different States' (Article 3 HSC).

10.03 In other words, the applicable law is a debatable issue arising from the presence of one or several foreign elements. The situation is international, for example, if: an intermediary has its registered office or domicile in another State; the securities account is maintained in another State; the issuing company has its registered office in another State or is subject to foreign law; the register of account holders is kept in another State; or the securities are held with a central depository located in another State. The decisive factor in determining whether a situation is 'international' is whether the foreign elemenr creates some doubt as to which law should apply to a right in intermediated securities.

10.04 In practice, nearly all situations involving intermediated securities have a sufficient foreign element causing them to fall within the scope of the HSC. It seldom occurs that intermediated securities issued by a company with a registered office in State A, held with a central depository in State A, are the subject of a transaction between two persons both domiciled in State A, both of whose intermediaries are also located in State A and hold the securities account in State A. However, any situation other than this is 'international'. Furthermore, the mere designation of a foreign legal regime by the parties to an account agreement is sufficient to make the situation 'international'.

10.05 A situation involving intermediated securities may be domestic to begin with but become international when a certain event occurs. For example, granting a security interest in intermediated securities in favour of a person domiciled abroad introduces a sufficiently foreign element to make the entire situation international. Any person participating in a transaction involving intermediated securities must therefore expect the HSC to apply at some time, by virtue of the appearance of a foreign element.

C. History of the Hague Securities Convention

(1) Object of the Hague Securities Convention

10.06 The classic rules of private international law refer to the law of the place where the security is located ('*lex rei sitae*' or '*lex chartae sitae*'). While this connecting factor is suited to a direct holding system based on the physical transfer of securities, it is inappropriate to an indirect holding system based on the immobilization and dematerialization of securities. Any attempt to apply this factor to such a system is likely to produce unexpected or even unmanageable results in practice. For example, in the context of a transaction involving a portfolio of securities located in different States, the idea of referring each security to the law of the place where it is located has the unfortunate effect of multiplying the applicable laws. If this factor is applied to the granting of a security interest in a securities account, it is in practice impossible for the beneficiary to fulfil the perfection requirements of all the laws applicable to all the securities. The development of an intermediated system for holding securities has therefore given rise to significant legal uncertainty in private international law.

10.07 It is in this context that an international review was launched early in 2000 under the aegis of the Hague Conference on Private International Law. It followed a joint proposal by Australia, the UK, and the US to set up an international convention with a view to establishing modern conflict rules reflecting the fact that securities are now held, transferred, and pledged indirectly. Harmonizing the rules of private international law seemed to be the best way of guaranteeing legal certainty.

10.08 The work of the Hague Conference was based on two guiding principles: on the one hand, the need to modernize the traditional conflict of laws rules that exist in most States, and, on the other, to set up a system of connecting factors that would guarantee legal predictability and thus provide legal certainty. Given the urgent needs of practitioners, the States rapidly reached an agreement, and the text of a new Hague Convention was adopted in December 2002.[1]

[1] Goode et al., *Explanatory Report*, Int–1 to Int–15.

(2) Status of the Hague Securities Convention

10.09 The HSC was signed jointly by Switzerland and the US on 5 July 2006. Switzerland was the first State to ratify the HSC, on 14 September 2009. It was followed by the Republic of Mauritius on 15 October 2009. No other State has signed or ratified the Convention yet. Since the HSC will enter into force after the deposit of three instruments of ratification, it has not yet entered into force. The HSC did, however, enter into force for Switzerland on 1 January 2010, having been incorporated directly into the Swiss Private International Law Act (article 108c).[2]

10.10 Within the European Union, ratification of the HSC has been postponed because the system of connecting factors relating to rights in securities held with an intermediary adopted in European law is different from the system finally adopted in the HSC. Whereas the Convention refers to the law designated by the parties to an account agreement, the European legislator chose to subject the rights in securities held with an intermediary to the law of the place where the securities account is located.[3] This connecting factor is based on the 'place of the relevant intermediary approach' (PRIMA) conflict rule, which was used as the basis for initial discussion during the process of drafting the HSC. It refers to the place where the account holder's direct intermediary—described as the 'relevant intermediary'—maintains the former's securities account. In the course of negotiations at The Hague, the PRIMA conflict rule was long retained as the principal connecting factor to be used for the purposes of the HSC. The formulation of this connecting factor gave rise to numerous problems, however, arising from the practical difficulty of identifying the location of the relevant intermediary or of the securities account it maintains for the account holder. It is not unusual for the various activities involved in maintaining a securities account to be dispersed among offices located in a number of different States, or distributed among a number of sub-contractors located in different States. Moreover, the location of a securities account may easily be changed. The PRIMA conflict rule was not adopted ultimately because the negotiators considered that it was too difficult—or even impossible—to determine, in practice, the place where a securities account is located.[4] The subjective, rather than the objective, approach has therefore been preferred in the HSC.

10.11 Several States are currently debating a possible ratification of the HSC (for example, the US, Canada, Japan, and several Latin American States). However, the Geneva Securities Convention (GSC) is in competition with the HSC, for there is less need for conflict of law rules when national substantive laws are harmonized.[5]

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[2] Guillaume, 'Preliminary Remarks', 6.9–7.11.

[3] See s J(1).

[4] Goode et al., *Explanatory Report*, Int–41 to Int–46. See also paras 10.71–3.

[5] See s I.

D. Scope of the Hague Securities Convention

10.12 The HSC applies to 'securities held with an intermediary'. The definition of this term has been given in the Convention for the first time in a legal text (section D(1)). The HSC determines the law applicable to issues falling within its scope of application (section D(2)). Since the scope of the HSC is limited to determining the applicable law, it does not apply to questions relating to the competence of the authorities, nor to the recognition and enforcement of foreign decisions. These matters must be dealt with according to the private international law rules of each State. Furthermore, some issues are explicitly excluded in order precisely to circumscribe the scope of the HSC (section D(3)).[6]

(1) Definition of 'securities held with an intermediary'

10.13 The HSC applies only to securities held with an intermediary. In order for a security to be an 'intermediated security', it must be entered into an indirect holding system by being credited to a securities account held with an intermediary. The account holder may be an investor or another financial intermediary, or the intermediary itself. The Convention is not applicable as long as a security is held directly; nor does it apply to cash.

10.14 According to Article 1(1)(f) HSC, 'securities held with an intermediary means the rights of an account holder resulting from a credit of securities to a securities account'. This definition gains in substance when read in the context of the other definitions in Article 1. Securities held with an intermediary are thus securities, that is, 'any shares, bonds or other financial instruments or assets (other than cash), or any right to such securities' (Article 1(1)(a)), held with an intermediary, that is, 'a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity' (Article 1(1)(c)). Central securities depositories are intermediaries (Article 1(4)), as are banks, securities dealers, and other financial intermediaries that maintain securities accounts in the course of their business activity. By contrast, persons who act as registrars or transfer agents for an issuer of securities, as well as those who act purely as managers or administrators of securities accounts, are not intermediaries within the meaning of the HSC (Article 1(3)).

(2) Issues falling within the scope of the Hague Securities Convention

10.15 Article 2(1) HSC provides an exhaustive list of issues that fall within the scope of the HSC. This list is meant to include all issues in respect of rights in intermediated

[6] Sections D–H are inspired by Guillaume, 'Convention', 29–81 (Arts 1–11 HSC).

securities that are of practical importance, irrespective of the way these issues are treated in the private international law rules of the States concerned. Often, the same matter falls under two different letters of the list in Article 2(1). It is not necessary to determine precisely which letter governs any particular matter. If it falls within at least one of the topics listed, then the HSC applies.[7]

10.16 The law designated by the HSC applies to the following issues:

(i) 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(1)(a));
(ii) the legal nature and effects against the intermediary and third parties of a disposition of intermediated securities (Article 2(1)(b));
(iii) the requirements for perfection of a disposition of intermediated securities (Article 2(1)(c));
(iv) the priority among competing rights (Article 2(1)(d));
(v) the obligations of an intermediary in cases where a competing right is invoked (Article 2(1)(e));
(vi) the requirements for the realization of an interest in an intermediated security (Article 2(1)(f)); and
(vii) whether the disposition of an intermediated security extends to entitlement to dividends and other proceeds of that security (Article 2(1)(g)).

10.17 The rights specified in Article 2(1) relate either to the intermediated security itself, or to its disposition. Within the context of the HSC, the disposition of a security held with an intermediary refers to (i) any transfer of title, whether outright or by way of security, and (ii) any grant of a security interest, whether possessory or non-possessory (Article 1(1)(h)). Its scope therefore includes sales and purchases of securities, repurchase agreements, sell/buy-back transfers, stock loans, and security interests. Non-possessory security interests that fall within the scope of the HSC are those that can be granted without crediting the securities to the collateral taker's securities account, simply by means of an agreement between the account holder and an intermediary that grants control over the securities to the collateral taker. A disposition of securities may refer either to the transfer of all or some of the securities in a securities account, or to the transfer of the securities account itself (Article 1(2)(a)). This may be done in favour of either the account holder or its intermediary (Article 1(2)(b)). A lien by operation of law in favour of an intermediary, such as a right of retention, is also considered a disposition within the meaning of the HSC (Article 1(2)(c)).

10.18 The HSC applies whether or not the designated law is that of a contracting State (Article 9). The law designated by the HSC may be refused only if the effects of its

[7] Goode et al., *Explanatory Report*, 2–9.

application would be manifestly contrary to the public policy of the forum (Article 11(1)). Bearing in mind the adverb 'manifestly', the public policy exception can only be invoked, with reserve, in situations where the application of a foreign substantive law rule would be diametrically opposed to the essential principles of the legal system of the forum. This limitation of the scope of public policy is intended to reinforce legal certainty.[8]

(3) Issues excluded from the scope of the Hague Securities Convention

10.19 Anything not included in the list of Article 2(1) HSC is not governed by the law designated by the HSC.

10.20 In particular, the HSC does not apply to purely contractual or personal rights (Article 2(3)(a) and (b)). These rights derive from the legal contractual status and are governed by the contract rules of the private international law of each State. All rights arising exclusively from the contractual relationship between an account holder and its intermediary (or between two intermediaries) fall outside the scope of the HSC. These include, for example, matters relating to the degree of diligence expected of the intermediary in maintaining securities accounts; the contents and frequency of account statements; risks of loss; securities prices; the date on which securities must be transferred against payment; and the consequences of a violation by one of the parties in the course of a disposition of securities or in payment for securities at maturity. Contractual rights between parties to a disposition of intermediated securities likewise do not fall within the scope of the HSC.

10.21 The HSC does not apply to the rights and obligations of an issuer of securities, whether in relation to the holder of the securities or to any other person (Article 2(3)(c)). These rights depend on the legal status of the issuing company and are governed by the law applicable to the latter in accordance with the private international law rules of each State. The law applicable to the issuing company determines, for example, entitlement to income payments (for example, dividends or interest); the type of voting right attaching to securities; and the requirements with regard to granting free shares.

10.22 The regulation of financial markets does not fall within the scope of the HSC.[9] The regulatory provisions relating to the issue or trading of securities as well as those relating to supervision of financial markets contained in the law of the forum are thus applicable regardless of the law designated by the HSC. Such mandatory provisions of the forum, whose application is required regardless of the law designated by the HSC (in other words, 'internationally mandatory rules' or '*lois d'application immédiate*'), are expressly reserved at Article 11(2). Among the forum laws that

[8] Goode et al., *Explanatory Report*, 11–6.

[9] Sigman and Bernasconi, 'Myths', esp. 31–2.

could apply on grounds of public policy are also its regulations on the prevention of financial crime and money laundering, including the degree of diligence required of financial intermediaries; tax rules; and rules intended to safeguard banking secrecy.

E. Choice of Law as the Primary Rule

10.23 The HSC refers primarily to the choice of applicable law by the parties to an account agreement (section E(1)). This subjective connecting factor has the great advantage of avoiding the need to localize a securities account held with an intermediary in order to determine the law applicable to the rights arising from a credit to the account. However, the parties to an account agreement have only limited freedom to choose the law applicable to issues falling within the scope of the HSC. Such a choice is valid only if the intermediary has a qualifying office in the State whose law has been designated by the parties (section E(2)).

10.24 When a transaction in intermediated securities involves a chain of intermediaries, the applicable law is not determined globally for the entite chain. It is designated separately for each securities account. The HSC does not permit the designation of a single law to govern all matters falling within its scope in respect of all the securities accounts maintained by the intermediaries located between the investor and the issuing company. A single transaction (for example, the acquisition of securities) may thus be governed by different laws at each level in the chain of intermediaries.[10] Even if a single intermediary performs the transaction by debiting and crediting two or more securities accounts that it maintains for different investors, it is still possible—if only in theory—for a different law to apply to each securities account.

(1) Law designated by the parties to an account agreement

10.25 The law applicable to rights in intermediated securities is the law designated by the account holder and its direct intermediary by means of an express *electio juris* in the account agreement between them (Article 4(1) first senrence HSC).

10.26 The account holder's direct intermediary, which maintains its securities account, is deemed to be the 'relevant intermediary' (Article 1(1)(g)). The word 'relevant' highlights the fact that this intermediary is decisive in defining the connecting factor. The intermediary that maintains a securities account is always the relevant intermediary in respect of that account. This is true even if a disposition of securities is made in its favour (Article 4(3)).

[10] Goode et al., *Explanatory Report*, 4–43 to 4–51.

10.27 To be valid pursuant to the HSC, the choice of law must be explicit. It cannot derive implicitly from the provisions of the account agreement or from external circumstances. It may be contained in the account agreement in the broader sense: it may appear in an annex, such as terms and conditions.[11] Although Article 4(1) does not require the choice of law to be made in writing, it is difficult to imagine a situation in which it could validly be made orally.

10.28 The choice of law may be either (i) general, in which case it applies to all legal relationships between the parties, including issues falling within the scope of the HSC, or (ii) specific, applying only to issues falling within the scope of the HSC. The law applicable to issues falling within the scope of the HSC is therefore not necessarily the same as that governing other aspects of the legal relationship between the parties to the account agreement. The parties can choose the law of State A for their contractual relationships and the law of State B for issues specified in Article 2(1). The choice of law governing the parties' contractual relationships must comply with the private international law rules of the forum if it is to be valid. If the parties have chosen a single applicable law without specifying a different law to govern issues falling within the scope of the HSC, then that law also applies automatically to these issues. In such a case, the choice of law must, if it is to be valid, comply not only with the HSC requirements but also with those of the private international law rules of the forum.

10.29 A single law governs all legal issues specified in Article 2(1) relating to intermediated securities that are credited to a particular securities account. The applicable law cannot be fragmented by stipulating that a different law shall apply to some of the issues specified in Article 2(1).[12]

(2) Requirement of qualifying office

10.30 The parties to an account agreement cannot choose just any law. The choice of law is valid only if the intermediary has a qualifying office in the State whose law has been designated by the parties (Article 4(1) second sentence HSC).

10.31 An intermediary is deemed to have an 'office' at any place of business in which any of its activities are carried on (Article 1(1)(j)). Therefore, it has an office at any place in which it has a registered office, branch, or agency. A place of business which is intended to be merely temporary or a place of business of any person other than the intermediary is not an office within the meaning of the HSC (Article 1(1)(j) *in fine*). The place of business of a subsidiary or another company belonging to the intermediary's group is thus not an 'office' as defined in the HSC.[13]

[11] Goode et al., *Explanatory Report*, 4–18.
[12] Goode et al., *Explanatory Report*, 4–10.
[13] Goode et al., *Explanatory Report*, 1–25.

10.32 An intermediary has a 'qualifying office' if it has an office in the State whose law has been designated in the account agreement and this office is either (i) engaged in a business or other regular activity relating to the maintenance of securities accounts (Article 4(1)(a)), or (ii) identified as holding securities accounts in that State by an account number, bank code, or other specific means of identification (Article 4(1)(b)). In any event, an office will not be deemed to be a qualifying office if it engages only in limited activities related to the maintenance of securities accounts (for example, processing electronic data or operating a call centre) in the State whose law has been chosen in the account agreement (Article 4(2)(a)–(c)). Moreover, an office that engages solely in representational or administrative functions and does not have authority to enter into an account agreement cannot be deemed a qualifying office (Article 4(2)(d)).

10.33 An intermediary's qualifying office need not necessarily maintain the securities account in respect of which a question arises. The choice of law is valid as long as the intermediary has an office that engages in an activity relating to the maintenance of securities accounts in the State whose law has been chosen.[14] The securities account in respect of which a question is raised may therefore be held by any other office of the intermediary or even by one or more sub-contractors, regardless of their locations. For example, if the parties to an account agreement have chosen the law of State B for issues within the scope of the HSC, this choice is valid if the intermediary has an office in State B, even if the securities account in question is held partly in State C by another office of the intermediary and partly in State D by one of its sub-contractors.

10.34 The qualifying office requirement must be fulfilled at the time the choice of law is agreed (Article 4(1) second sentence). This is generally at the same time as the account agreement is entered into. If the intermediary has no qualifying office in the State whose law has been chosen by the parties at that time, the choice of law is not valid. In such a case, the law applicable to rights in intermediated securities credited to the account in question must be determined pursuant to Article 5.[15] If the intermediary later sets up a qualifying office in the State whose law is designated in the account agreement, this does not remedy the initial defect. In such a case, the choice of law must be made afresh in the account agreement, or at least the existing choice of law clause must be expressly confirmed if the choice of law is thenceforth to be valid.[16] Conversely, if at the time the choice of law was agreed the intermediary had a qualifying office in the State whose law was chosen, but this office later ceases to be a qualifying one, the choice of law remains valid.

10.35 The qualifying office requirement is intended to prevent parties from choosing a law solely for the advantages it offers them. It must be acknowledged, however,

[14] Goode et al., *Explanatory Report*, 4–23.
[15] See s F.
[16] Goode et al., *Explanatory Report*, 4–27.

that this requirement can very easily be fulfilled by the intermediary, the more so because it is not necessary for the securities account to be held by the qualifying office. Since it is unlikely that any private investor will be in a position to oppose a choice of law proposed by its direct intermediary, the latter has a degree of freedom to choose the law that best serves its interests in its relationships with investors. However, the power relationship may be reversed in the case of institutional investors. Such investors are in a better position to impose the law of their choice on their intermediary, for example, in order to subject all their transactions to the same law. Likewise, in the context of relationships between two financial intermediaries, the intermediary that holds the securities account on behalf of the other intermediary is not necessarily the one that is in a position to impose the applicable law.

10.36 The qualifying office requirement is the only limitation to the freedom of the parties to an account agreement to choose the applicable law to issues falling within the scope of the HSC. To a certain extent the qualifying office requirement addresses the risk of fraud. Therefore, it should nor be possible to invoke fraud as grounds for invalidating the choice of law made by the parties to an account agreement.[17] However, the intermediary may be forced to choose a specific law by regulatory provisions;[18] it may even be a precondition to participation in a system. Such regulatory provisions would apply on grounds of public policy (Article 11(2)).

F. Fall-back Rules

10.37 The choice of law rule is supplemented by a cascade of fall-back rules that apply in the event that (i) the parties have not designated the applicable law in their account agreement, or (ii) the choice of law is not valid (Article 5 HSC). The fall-back rules provided in Article 5 are objective rules based on the PRIMA connecting factor, which refers to the place where the account holder's direct intermediary—described as the 'relevant intermediary'—maintains the former's securities account.[19] More precisely, it refers to the law of the place where the intermediary has an office (section F(1)), the law under which it is incorporated or otherwise organized (section F(2)), or the law of the place where it has its principal place of business (section F(3)). The decisive moment is the time the account agreement was entered into, or the time the securities account was opened if there is no account agreement.

10.38 The fall-back rules are of only marginal importance, since cases where there has been no choice of law or no valid choice of law are rare in practice. The main case where a choice of law is not valid is where the direct intermediary did not have an

[17] Goode et al., *Explanatory Report*, 3–10 and 11–5.
[18] Sigman and Bernasconi, 'Myths', 32.
[19] See para 10.10.

office in the State whose law was chosen by the parties at the time the choice of law was made (ie, it did not comply with the qualifying office requirement).[20]

(1) Law of the place of the relevant intermediary's office

10.39 The first fall-back rule designates the law in force in the State where the office of the relevant intermediary, which has unambiguously entered into a written account agreement, is located (Article 5(1) HSC). In order for this fall-back rule to apply, the account agreement must expressly state that it has been entered into through a particular office. Moreover, this office must be a qualifying office within the meaning of Article 4 HSC.

(2) Law under which the relevant intermediary is incorporated or otherwise organized

10.40 The second fall-back rule designates the law in force in the State under whose law the relevant intermediary is incorporated or otherwise organized (Article 5(2) HSC). This rule is subsidiary to the preceding one, meaning that it can only be invoked if the office through which the account agreement was entered into cannot be determined with certainty, or if there was no qualifying office within the meaning of Article 4 HSC. It applies, of course, only to intermediaries that are companies.

(3) Law of the relevant intermediary's principal place of business

10.41 The third fall-back rule designates the law of the State in which the relevant intermediary has its principal place of business (Article 5(3) HSC). This rule is subsidiary to the two preceding ones. Thus, it can only be invoked if the relevant intermediary has not been validly incorporated or otherwise organized. However, as a matter of fact, it is difficult to imagine that a company could be considered an intermediary without being validly incorporated or organized in accordance with the law of a State. Arguably, even if this last fall-back rule has been clearly drawn up for companies, it should only be applied to intermediaries that are individuals. In practice, therefore, the rule should not often apply.

G. Factors to be Disregarded When Determining the Applicable Law

10.42 Article 6 HSC supplements Articles 4 and 5 by drawing up a negative list of connecting factors that are to be disregarded when determining the law applicable to rights in intermediated securities. This provision is intended unambiguously to exclude all connecting factors traditionally applied to determining the law applicable to

[20] See s E(2).

securities held within a direct holding system.[21] The irrelevance of these criteria is already apparent from an *a contrario* interpretation of Articles 4 and 5.

10.43 The law applicable to the matters specified in Article 2(1) cannot be determined with regard (i) to the place where the issuing company is incorporated, otherwise organized, or has its statutory seat, registered office, or principal place of business, or (ii) to the place where the securities are located, or (iii) to the place where a register of holders of securities maintained by or on behalf of the issuing company is located (Article 6(a)–(c)). Furthermore, only the account holder's direct intermediary is decisive in determining the applicable law (Article 6(d)). It is not possible to take account of another intermediary in the chain. In particular, the applicable law cannot be found by treating the direct intermediary as transparent and referring to another higher-level intermediary, or by referring directly to the issuing company. The so-called 'look-through approach' is not applicable.[22]

H. Third-party Rights

10.44 The system of connecting factors of the HSC is centred on the specific relationship between an account holder and the direct intermediary that maintains its securities account. These two persons may choose which law shall apply to their rights in the intermediated securities credited to the account (Article 4 HSC). This choice of law will nevertheless affect the rights of third parties. The chosen law will apply to the rights of any other person (for example, a creditor) in the same intermediated securities (Article 2(1)). For example, the requirements for perfection of a disposition of intermediated securities, as well as priority among competing rights, are governed by the law designated by the HSC. It should be added that requirements arising from a law other than the one determined under the HSC cannot be imposed over and above that law on grounds of public policy (Article 11(3)). For example, a procedure for registering securities in a special register stipulated by a law other than the one designated by the HSC cannot be imposed on grounds of public policy. The HSC provides special rules to protect third-party rights in two situations where they are particularly vulnerable. The first situation occurs when the parties to an account agreement agree to change the applicable law (section H(1)). The second comes into play when insolvency proceedings have been opened against one of the participants in the indirect holding system (section H(2)).

(1) Change of the applicable law

10.45 The issue of third-party rights on a change of applicable law arises if the parties to the account agreement decide to change the law applicable to interests in

[21] Goode et al., *Explanatory Report*, 6–1.

[22] Goode et al., *Explanatory Report*, 6–2 and Int–37 to Int–40.

intermediated securities by making a choice of law. They may, for example, insert a choice of law clause into an account agreement that did not previously include one. They may also insert into an account agreement, which already contains a general choice of law clause, a special clause designating the law applicable to the issues specified in Article 2(1) HSC. They may also change the law designated in a pre-existing clause.

10.46 If the conditions for choosing a law as specified in Article 4 HSC are satisfied,[23] the new law designated by the parties to the account agreement will apply retroactively, replacing *ab initio* the law that was previously applicable (Article 7(3)). The new law will thus govern all interests in the intermediated securities that were credited to the securities account both before and after the change of the applicable law. Therefore, the rights of third parties may be endangered if they are not informed of the change of law agreed upon by the parties to an account agreement.[24]

10.47 The risk of harm to third parties' rights in such situations is reduced by Article 7(4), which provides that interests acquired by third parties prior to the change of law are neither restricted nor set aside if the parties to an account agreement agree to change the applicable law. The old law remains applicable in principle to third parties for all issues in respect of (i) the existence of an interest in intermediated securities arising before the change of law, (ii) interests arising from a disposition of securities that were perfected before the change of law, and (iii) priority as between parties whose interests arose before the change of law (Article 7(4)(a)–(c)). However, if an interest in an intermediated security that arose before the change of law was not perfected under the old applicable law, but was subsequently perfected under the new applicable law, then the latter applies to issues of priority (Article 7(5)).

10.48 Article 7(4) applies only to third parties who have not been informed of the change of applicable law agreed upon by the parties to an account agreement. The new applicable law is thus applicable to third parties who were informed of and consented to the change of law made by the parties to the account agreement (Article 7(4) *cum* Article 7(3)). It is not necessary to afford any protection to the rights of an informed third party, inasmuch as it has itself the means necessary to protect them. For example, if the collateral taker was informed of and consented to the change of law made by the parties to the account agreement, the newly chosen law applies to the collateral taker's rights in the pledged securities. This new law applies in respect of the collateral taker, and does so retroactively, as soon as it has given its consent. This means that it must make its security interest effective in accordance with the requirements of the new law designated by the parties to the account agreement.

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[23] See s E.

[24] Guillaume, '*Electio juris*', esp. 75–6; Sigman and Bernasconi, 'Myths', 34.

(2) Opening insolvency proceedings

10.49 The issue of third-party rights where insolvency proceedings are opened against one of the participants in the indirect holding system (for example, an investor, an intermediary, a depository, or an issuing company) is a sensitive one. The opening of insolvency proceedings makes it necessary to determine whether and to what extent the rights a creditor has acquired in intermediated securities before the proceedings commenced are maintained and may be enforced after they have opened.[25]

10.50 The HSC provides that all rights acquired pursuant to the law that it designates must be recognized in the context of subsequent insolvency proceedings (Article 8(1)). For example, if an intermediated security was credited to a securities account before the opening of bankruptcy proceedings against the intermediary maintaining the securities account, the rights of the account holder continue to be governed by the law designated by the HSC. Therefore, the place where the insolvency proceedings have been opened does not affect the law applicable to the perfection of rights in the intermediated securities.

10.51 However, the HSC has no effect on 'the application of any substantive or procedural insolvency rules, including any rules relating to a) the tanking of categories of claim or the avoidance of a disposition as a preference or a transfer in fraud of creditors; or b) the enforcement of rights after the opening of an insolvency proceeding' (Article 8(2)). Only the insolvency law (ie, in principle, the law of the place where the bankruptcy proceedings have been opened) can determine the effects of rights in intermediated securities in the context of such proceedings. In the above example, it is the insolvency law that determines, among other things, whether or not the tights of the account holder in the securities credited to its account have priority over the rights of othet creditors of the bankrupt intermediary.

I. Relationship between the Hague Securities Convention and the Geneva Securities Convention

10.52 This section analyses the relationships between the HSC and the GSC. First, we describe the key idea—the fact that the sphere of application of the GSC is not determined by itself but by the conflict of laws rules applicable in each State (the conflict of law rules of the forum) (section I(1)). Second, we point out the main consequence of this idea, ie, the fact that the HSC determines, at least in part, the application of the GSC, assuming that both instruments have come into force

[25] For a detailed analysis of the consequences of the opening of insolvency proceedings in respect of the rights of third parties, see Guillaume, '*Electio juris*', 77–82.

(section I(2)). Finally, we explain the consistency of the approaches adopted by these two instruments (section I(3)).

(1) Sphere of application of the Geneva Securities Convention

10.53 The GSC deals with substantive law and not with private international law. However, even if this Convention were to be adopted by all States, since many aspects are still left to the 'non-Convention law', the conflict of laws rules would continue to play a very important role.

10.54 The GSC does not lay down any connecting factor that triggers its application, which is determined instead by the conflict of laws rules of the forum. This idea is stated in Article 2(a) GSC. The Convention applies whenever the applicable conflict of laws rules designate the law in force in a Contracting State as the applicable law. The reason for this approach is clear. Once the GSC has been ratified by a State, it becomes part of the substantive national law of that State. Therefore, the rules of the GSC will apply insofar as the substantive law of that State is the applicable law under the conflict of laws rules of the forum.[26]

10.55 As a consequence, even if the forum is a Contracting State to the GSC, this text does not apply when its conflict of laws rules point to the law of a non-Contracting State as the applicable law on an issue. And *vice versa*: even if the forum is a non-Contracting State, the GSC will apply (as part of the *lex causae*) if the conflict of laws rules of that State point to the law of a Contracting State as the applicable law.[27]

10.56 Together with Article 2 GSC, Article 3 clarifies the effect of conflict of laws rules on declarations. Since the declarations established by the GSC are related to its substantive rules, mainly allowing Contracting States to opt into or out of the uniform rules, the application of such declarations is also determined by the conflict of laws rules of the forum.

(2) Interaction between the Hague Securities Convention and the Geneva Securities Convention

10.57 The HSC and the GSC are texts of a different nature. The former is a conflict of laws instrument and the latter a material-law instrument. Application of the GSC is, therefore, determined by the HSC.

10.58 However, the substantive scope of application of the HSC is not exactly the same as the substantive scope of the GSC. Article 2(1)(a)–(g) HSC contains an exhaustive list of all the issues falling within the scope of the HSC, which is narrower than the scope of the GSC.[28] The HSC applies to rights that relate to either the securities

[26] Kanda et al., *Official Commentary*, 2–6.

[27] Kanda et al., *Official Commentary*, 2–7 and 2–9.

[28] See paras 10.15–18.

themselves and result from a credit of securities to a securities account, or the disposition of securities held with an intermediary. Although the concept is avoided, the HSC applies mainly to 'proprietary' issues. However, purely contractual or personal rights that arise solely from the contractual relationship between the account holder and its intermediary or the parties to a disposition *inter se* are not included within the scope of the HSC (Article 2(3)(a)).[29]

10.59 Assuming the HSC were in force in a Contracting State, all the issues mentioned in Article 2(1)(a)–(g) would be governed by the applicable law determined under Article 4 or one of the fall-back rules provided in Article 5. Furthermore, it is important to note that the *same law* applies to all of the Article 2(1) issues. It is not possible, therefore, for some of these issues to be governed by one law while others are governed by a different one.[30]

10.60 Conversely, the GSC contains rules of a very different nature. Rules on: (i) the effectiveness against the intermediary and third parties of the account holder's rights over the securities (for example, Articles 9, 11, and 12); (ii) the effectiveness against the insolvency administrator (for example, Articles 14 and 21); (iii) the contractual relationships between the intermediary and its account holder (for example, Article 10); (iv) or even the exercise of certain rights against the issuer (for example, Article 29). There is no single, all-encompassing conflict of laws rule applicable to all these issues. From a conflict of laws perspective, each of these issues has to be filed in one of the legal categories used by the conflict of laws rules of the forum to determine the applicable law and, accordingly, whether the GSC applies.[31]

10.61 Having said that, the interaction between the HSC and the GSC is easy to understand. Within its substantive scope of application, ie, with regard to Article 2(1) HSC issues,[32] the HSC determines the applicable law. If the law is that of a Contracting State to the GSC, this instrument will govern all substantive issues included within that substantive scope. As an example, let us assume that State A has ratified the HSC and, according to this instrument, State B's law is applicable. All issues included in Article 2(1) HSC are therefore governed by the law of State B. If State B is a party to the GSC, then the GSC will apply to those issues (or, where appropriate, the 'non-Convention law' as defined in Article 1(m) GSC). Note that because the HSC has a universal scope of application (Article 9), the question of whether State B is a party to the HSC is not relevant.

10.62 The law applicable to other issues that are outside the substantive scope of the HSC but may fall within the scope of the GSC is determined by the corresponding

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[29] Goode et al., *Explanatory Report*, 2–4. See also para 10.20.

[30] Kanda et al., *Official Commentary*, 4–10. See also para 10.29.

[31] See, with further details, Garcimartín, 'The Geneva Convention'.

[32] See para 10.16.

conflict of laws rules of the forum. For example, the law applicable to the contractual obligations of the intermediary vis-à-vis its account holder is determined by the conflict of law rules on contractual obligations; in the EU; this is the Rome I Regulation. If the applicable law is that of a Contracting State to the GSC, the GSC's provisions on contractual obligarions will apply, for example, Article 10.

(3) Consistency of the two instruments: the 'tier-by-tier approach' as the building block

10.63 As a substantive-law instrument, the GSC is neutral from a conflict of laws perspective. The GSC does not determine the conflict of laws rule that a forum has to adopt and neither, for the same reason, does it determine whether or not *renvoi* is acceptable.[33] Nonetheless, the approach adopted by the GSC fits better with the conflict of laws approach of the HSC than with others, and vice versa: the conflict of laws approach followed by the HSC fits better with the substantive rules designed by the GSC.[34]

10.64 The GSC follows a 'tier-by-tier approach'. It divides the holding chain into tiers and looks at each link in that chain: *for each account holder there is one, and only one, relevant intermediary.* The building block of the GSC is each relationship between an account holder and *its relevant (or immediate) intermediary.* This concept of 'relevant intermediary' refers to the intermediary that keeps a particular securities account for a particular account holder, enabling that intermediary to be distinguished from any other intermediary in the holding chain. This lets the GSC focus on each tier individually and as independently as possible from what happens in other tiers of the same holding chain.[35]

10.65 This substantive approach works well with a conflict of laws approach whereby the applicable law is determined separately for each tier in the chain of intermediaries, as in the HSC.[36] Both the HSC rule and the EU rule determine the applicable law separately for each tier in the holding chain, ie, for each relationship between an account holder and its relevant intermediary.[37] There may only be one applicable law for each tier and, therefore, in a multi-tier structure there may be two or more layers of laws. This perfectly suits a substantive law regime that establishes the rules

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[33] Kanda et al., *Official Commentary*, 2–8.

[34] Chun, *Cross-border Transactions*, 422–3; Einsele, 'Das Haager Übereinkommen', 2354; Einsele, 'Modernising', 254–61; Einsele, 'Security Interests', 361–2; Garcimartín, 'The Geneva Convention', 754–5; Rögner, 'Inconsistencies', 104–5; Thévenoz, 'Intermediated Securities', 419–20.

[35] Thévenoz, 'Intermediated Securities', 420; see also Kanda et al., *Official Commentary*, 1–44.

[36] See para 10.24.

[37] Thévenoz, 'Intermediated Securities', 420: 'While they differ in respect of a subjective, choice-oriented test as opposed to an objective, location-oriented-test, the two rules converge in relying on the account to which the securities are credited and on the relevant intermediary who maintains that account'. See also para 10.72.

governing each relationship. As a result, a conflict of laws approach based on the relevant intermediary (ie, a 'tier-by-tier approach') rule sits easily with the GSC substantive regime. Conversely, a tier-by-tier approach is more difficult to reconcile with a substantive law regime based on the idea that the ultimate account holder has a direct ownership or co-ownership right over the underlying securities. This is one of the issues discussed comprehensively in section J.

J. Problems of the Hague Securities Convention: the European Debate

10.66 The purpose of this final section is to analyse the main problems raised by the HSC from a EU perspective. Section J(1) describes the *status quaestionis*, while section J(2) covers the debate on the merits of the HSC solutions. In addition, we examine ways to move forward (section J(3)).

(1) *Status quaestionis*

10.67 Three EU legal acts lay down a rule to determine the law applicable to rights in intermediated securities. These rules on the European *acquis* are worded slightly differently but are based on the same formula: the law is that of the Member State (or in some cases third State) in which the securities account that records the existence of those rights is located (held, maintained, or recorded). The relevant provisions are the following.

10.68 Article 9(2) of the EU Settlement Finality Directive (SFD):

> 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.

10.69 Article 24 of the Banks Insolvency Directive (BID):

> *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 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.

10.70 Article 9(1) of the Financial Collateral Directive (FCD):

> 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.

10.71 Both the conflict of laws rule adopted by the HSC and the regime that is currently applied in the European Union have a common starting point, but differ in the formulation of the connecting factor.

10.72 Both may be deemed sub-species of the PRIMA rule, since they are not based on the look-through approach but on the general principle that the immediate intermediary should in some way be the focus of the account holder's rights. As explained above, both converge on a 'tier-by-tier approach'.[38] In fact, they are likely to produce identical results in most situations.[39]

10.73 The HSC, however, is based on the law chosen in the account agreement between the account holder and the relevant intermediary, provided the 'qualifying office test' is met.[40] The PRIMA rule is based on an objective connecting factor: the location of the relevant account. The applicable law should be the law of the place where the record of title is maintained and where, therefore, orders in respect of the property can be effectively enforced.[41] *Ceteris paribus*, the main advantage of the HSC rule is that it offers a clear, easily ascertainable solution to those situations where the intermediary has different branches involved in the maintenance of securities accounts; with computer records it is not always clear where a securities account is located.[42] The choice of law eliminates this uncertainty.

10.74 It should also be noted that the scope of application of the HSC and the EU rules is very different. The HSC has a much broader scope: it provides a comprehensive treatment of all conflict of laws issues in respect of rights in intermediated securities that are of practical importance.[43] Conversely, the EU rules are mainly limited to situations where securities are used as collateral. In addition, the HSC attempts to offer an exhaustive private international law regime for intermediated securities, while the EU rules do not.

10.75 In December 2003, the EU Commission proposed that the Community sign the HSC.[44] This proposal provoked a wide-ranging debate about the merits of adopting the HSC. In July 2006, the EU Commission presented a working document on the consequences for the EU of adopting the HSC and explicitly concluded that the 'adoption

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[38] See paras 10.63–5.

[39] Thévenoz, 'Geneva Securities Convention', 11.

[40] See s E.

[41] See EC, Reflection Paper DG MARKT, 2, quoting materials produced early in the negotiation process leading to the HSC.

[42] See para 10.10.

[43] See para 10.16.

[44] EC, *Signing the Hague Convention*.

of the Convention would be in the best interests of the Community'.[45] In this document, the Commission also suggested that the SFD, BID, and FCD would need to be chauged and an amendment made to the SFD to eusure that only one law should be expressly chosen by all participants in an EU securities settlement and payment system.

10.76 However, in December 2006 the European Parliament adopted a resolution on the implication of signing the HSC.[46] The Parliament pointed out some of the drawbacks associated with the solutions of the HSC, and called for a comprehensive impact study on such drawbacks before it was signed on behalf of the EU. Three years later, in 2009, the Commission withdrew its proposal to sign the HSC.[47]

10.77 The EU Commission is currently working on a proposal on securities law legislation. It is considering the following options: (i) including a conflict of laws rule for intermediated securities retaining the location of the account criterion but clarifying its application when multiple branches are concerned ('Where an account provider has branches located in jurisdictions different from the head offices' jurisdiction, the account is maintained by the branch which handles the relationship with the account holder in relation to the securities account, otherwise by the head office');[48] (ii) and/or opting for the ratification of the HSC; or (iii) introducing a new approach.[49]

(2) Substantive debate

10.78 The European Parliament Resolution of December 2006 and the Opinion of the European Central Bank of March 2005[50] summarize the main concerns raised by the HSC in Europe. These concerns revolve around four aspects: (a) protection of third party rights, (b) interaction with substantive laws, (c) interaction with public law, and (d) the diversity of laws within a single securities settlement system (SSS).

(a) Protection of third party rights

10.79 The HSC determines the impact of the applicable law on third parties' rights.[51] In this regard, it has been argued that the choice of law made by an account holder and its intermediary would disadvantage third parties either because they (i) would not

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[45] EC, *Legal Assessment HSC*.

[46] OJ 2006 C317/904 (hereafter, 'European Parliament Resolution').

[47] OJ 2009 C71/17.

[48] EC, *Second Consultation: Legislation on Securities*, Principle 14. Article 46 of the proposed EU CSD Regulation (pCSDR) sets out a conflict of laws rule which is also based on the place where the account is maintained, with two additional clarifications: (i) where the account is used for settlement in a securities settlement system (SSS), the applicable law shall be the one governing that SSS; (ii) where the account is not used for settlement in an SSS, that account shall be presumed to be maintained at the place where the CSD has its habitual residence as determined by Art 19 of Regulation (EC) No 593/2008 of the European Parliament and the Council.

[49] See paras 10.98–101.

[50] ECB, 'Opinion'.

[51] See s H.

know about it (problem of transparency), or (ii) would find it detrimental to their interests (problem of abuse).

10.80 (i) Transparency It has been said that when the applicable law is chosen within the agreemenr between an account holder and its intermediary, it is not easy for third parties to discover that law: the account agreement is not a public document. This can be contrasted with the current situation in which the law can often be ascertained from objective facts, ie, the location of the relevant securities account, that do not require further enquiry.[52]

10.81 This argument, however, is not convincing. On the one hand, with regard to third parties seeking ro gain an interest in securities by agreement, for example, porential collateral takers, they already need to obtain information abour rhe existence of a securities account and its location. Under the HSC, these third parties will also want to know the law chosen by the account holdet and the intermediary. As the cooperarion of the account holder and its intermediary is always necessaty, the need to obtain this additional information will not constitute a significant change.[53] In general, third patties who want to acquire a proprietary right over the securities will always obtain information about which law governs such securities, whether under the current EU PRIMA rule or the HSC rule.

10.82 Other third parties may have had no prior dealings with the account holder as such, for example, ordinary public ot private creditors seeking to attach securities to enforce a debt. In order to attach securities, a creditor, or the competent authority, generally needs to establish the existence of a securities holding and the jurisdiction to which it is subject. Under the current EU PRIMA rule, that creditor needs to know where the securities account of its debtor is located. The HSC will not significantly alter this. The key issue is that establishing the location of a securities account normally requires the cooperation of the account holder and/or the intermediary (or intermediaries). In fact, in order to enforce the attachment, the competent authority will normally approach the intermediary to provide certain information and block the account. Therefore, the need to obtain a single piece of additional information, ie, the law chosen, would not materially compromise an attaching creditor's current position.[54]

[52] EC, *Legal Assessment HSC*, 11; ECB, 'Opinion', 15; Ooi, 'Critical Reading', 471; Ooi, 'Intermediated Securities', 226; Rögner, 'Inconsistencies', 104.

[53] EC, *Legal Assessment HSC*, 12; Sigman and Bernasconi, 'Myths', 34.

[54] EC, *Legal Assessment HSC*, 12; Sigman and Bernasconi, 'Myths', 34. There may be cases, nevertheless, where an objective connecting factor, such as a diagnostic number (similar to the International Bank Account Number), may make things easier for third parties in general and for potential attaching creditors and local authorities in particular. Thus, for example, if the jurisdictional rules remain based on the location of the account, under the HSC the number of cases in which the local authorities should have to apply a foreign law may increase *ceteris paribus*: see ECB, 'Opinion', 14. But this is a common scenario in cross-border situation and has to be balanced against the advantage of a global, standardized solution; see EC, *Legal Assessment HSC*, 13.

(ii) Abuse It has also been alleged that the possibility of choosing the applicable law may be used by intermediaries to select a law more favourable to them than to account holders or by both parties vis-à-vis secured creditors.[55] **10.83**

It is true that the HSC may facilitate 'law shopping strategies': in principle, it would appear to be easier to include a choice of law in the account agreement than to register or maintain the account in a particular place.[56] The situation under the HSC, however, is not very different from the current EU PRIMA rule. Under this rule, nothing prevents a domestic account holder from opening a securities account in a foreign jurisdiction with a local intermediary. There is no prohibition on locating accounts abroad. Parties already have the freedom, at least from a private international law standpoint, to choose where their securities accounts are held or maintained. By the same token, nothing prevents an intermediary from locating its clients' accounts in a particular office.[57] **10.84**

Finally, the idea that secured creditors may be disadvantaged by any subsequent changes to the choice of applicable law made without their consent is also unfounded. The pre-acquired rights of secured creditors are preserved by Article 7 HSC, the effect of which is that rights created under the applicable 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.[58] **10.85**

(b) Interaction with substantive law

The HSC is a pure conflict of laws Convention and does not affect or give rise to substantive law applicable to intermediated securities.[59] It is neutral on issues such as the nature of an account holder's rights or the requirements for creating or disposing of such rights. Nevertheless, as pointed out above, it has been argued that the solutions of the HSC correspond better to certain legal systems and, therefore, may *indirectly* affect the substantive law rules. These indirect effects have been considered in two areas: company law and securities law. **10.86**

The first issue is whether the Convention would jeopardize existing rules applying to companies. If the law governing corporate actions, such as the exercise of voting rights or payment of income, differs from the law chosen by the account holder and its intermediary, this will cause difficulties. By way of example, it has been suggested that an issuer will be prevented from knowing who the ultimate investor is, or that a situation could arise where, in order to determine who is entitled to exercise the rights arising from securities, an issuer would need to require each **10.87**

[55] European Parliament Resolution, 8.
[56] See para 10.35.
[57] Potok, 'Hague Securities Convention', 219; Sigman and Bernasconi, 'Myths', 34.
[58] See para 10.47.
[59] Goode et al., *Explanatory Report*, 2–1.

claimant to provide proof of entitlement, including the relevant account agreement. This would involve additional complications and expense.[60]

10.88 However, 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 (Article 2(3)(c) HSC).[61] This exclnsion encompasses the duties of the issuer with respect to all corporate actions, including voting rights and income. These matters would continue to be subject to the applicable corporate law, and would not be affected by the ratification of the HSC.[62] On the other hand, the difficulties of identifying the person entitled to exercise corporate rights derive from the very nature of intermediated holding systems. The preamble to the EU Shareholders' Rights Directive states: 'Where financial intermediaries are involved, the effectiveness of voting upon instructions relies, to a great extent, on the efficiency of the chain of intermediaries, given that investors are frequently unable to exercise the voting rights attached to their shares without the cooperation of every intermediary in the chain, who may not have an economic stake in the shares'. The complexity is inherent in the chain of intermediaries. The problem, therefore, is basically the same, regardless of whether the applicable law to the intermediated securities follows the HSC rule or the current EU PRIMA rule.

10.89 With regard to securities law, the argument has more weight but the conclusion is very similar. The HSC fits well with substantive laws based on a *trust* mechanism or on the creation of a new entitlement for each account holder vis-à-vis its intermediary. Conversely, it does not fit as well with substantive laws based on a direct proprietary right of the final investor—either an individual right or a pro rata collective right—over the securities deposited or registered at the issuer central securities depository (CSD). The same, it has been argued, holds with regard to transparent systems, where the names of the ultimate account holders are registered in individual segregated accounts at the level of the issuer CSD, and not at the level of their custodian only.

10.90 The reason can be summarized as follows.[63] The HSC is based on a tier-by-tier approach. The applicable law is determined separately for each tier in accordance with the choice of law made between the corresponding account holder and its intermediary.[64] This law determines the nature and effects of the rights of the account holder against its intermediary and third parties. Naturally, the nature of these rights may be different in each of those tiers. Along the chain of intermediaries, there is no, one, single overarching law, jnst different layers of laws. This fragmentation at the conflict of laws level, however, does not fit well with those legal

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[60] EC, *Legal Assessment HSC*, 13.
[61] See para 10.21.
[62] EC, *Legal Assessment HSC*, 14; Goode et al., *Explanatory Report*, 2–34.
[63] See n 35.
[64] Goode et al., *Explanatory Report*, 2–26; Ooi, 'Intermediated Securities', 237.

systems which, at the substantive law level, recognize a direct, individual, or collective ownership right of the (ultimate) investors over the original securities. Suppose that the issuer CSD is located in a jurisdiction that recognizes an investor's right to a direct pro rata ownership of the securities. However, the investor's securities are held through a custodian in another jurisdiction where law attributes to the account holder a bundle of rights only against its intermediary that may crystallize in a 'security entitlement' in an insolvency. These two systems are hard to reconcile. At least conceptually, it is difficult to understand how the investor may have a direct ownership right over the securities registered at the issuer CSD and, at the same time, have a 'security entitlement' enforceable only against its intermediary.

10.91 To a certain extent, a similar problem arises in a dynamic situation. The HSC fits well with legal systems where a transfer of intermediated securities implies that the transferor's rights are discharged and the transferee's rights are newly created. Conversely, it does not fit as well with legal systems where rights *in rem* over the securities are directly transferred and, therefore, what is acquired by the transferee derives directly from the transferor. The transferee acquires what the transferor loses, ie, under these substantive law systems, the rights *in rem* acquired by the transferee are the same as those lost by the transferor.[65] However, if each part of the transaction is governed by different laws, as may be the case under the HSC, the acquisition by the transferee can, and should, be analysed independently from the question of whether the transferor has lost its rights. The acquisition side and disposition side of the transaction may be governed by different laws and therefore analysed independently. As in the static example, this may lead to conceptually conflicting results, for example, the so-called 'double interest' situation.[66]

10.92 Nevertheless, this is not a problem arising specifically from the HSC. It is again an issue linked to the PRIMA rule.[67] This rule, whether the HSC or current EU version, creates different layers of laws. If the chain of intermediaries crosses different jurisdictions, different laws will apply, one to each intermediary. This means that problems of cross-border compatibilities may always arise, like those mentioned above. That is why the HSC calls for a Convention on substantive law ensuring the compatibility between the conflict and the material law levels.[68]

10.93 Finally, with regard to *transparent systems*, the solution offered by the HSC seems appropriate. According to Article 1(3)(b) HSC mere account operators are not

[65] Einsele, 'Modernising', 255.

[66] EC, *Legal Assessment HSC*, 10; Einsele, 'Modernising', 255; Garcimartín, 'Disposition and Acquisition', 749–50; Rögner, 'Inconsistencies', 104; Ooi, 'Critical Reading', 484–7; Ooi, 'Intermediated Securities', 227. Goode et al., *Explanatory Report*, 4–43 to 4–51 deal with this problem, but only from a conflict of laws perspective.

[67] Chun, *Cross-border Transactions*, 416–17; Goode et al., *Explanatory Report*, 4–49; Haentjens, *Harmonisation*, 233, 290; Morton, 'Security Interests', 370–1.

[68] *Inter alia*, Einsele, 'Modernising', 256; Thévenoz, 'Intermediated Securities', 426–30.

considered intermediaries. If a financial institution opens a securities account with a third party in the name of the customer, the financial institution itself, even if it keeps a parallel record of the customer's holding, will not be considered an intermediary under the HSC.[69] If the investor has an individually segregated securities account under its name at the level of the issuer CSD, this will be the relevant account from a conflict of laws standpoint. This avoids problems of substantive incompatibilities, since the rights of the investor in the securities are governed by one single law, not by different layers of laws. Therefore, if the intention is to give final investors the option to open individually segregated accounts at the issuer CSD level, Article 1(3)(b) HSC may also provide an adequate solution.

(c) Interaction with public law

10.94 It has been argued that the HSC may interfere with the enforcement of public laws. In particular, concern has been raised of a possible risk of conflict between the HSC and 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 chosen non-EU law, especially when those duties are based on the locarion of the account.[70] It has also been said that the autonomy of the parties may be used to disempower supervisory authorities. The promotion of party autonomy under the HSC may interfere, directly or indirectly, with the application of public laws based on the location of the account.[71]

10.95 However, the HSC deals only with private law issues (Article 2). Regulatory measures are excluded and the HSC therefore affects the scope of neither the application of public laws nor the powers of national authorities.[72] Normally, these laws are based on personal and/or territorial rules, which use objective connecting factors to determine their scope of application, independent of private agreements. The choice of law of a non-EU State will therefore have no impact on the transaction reporting or tax obligations imposed on an intermediary, account holder, or any other person concerned with securities held in the relevant securities account.[73] For the same reason, the HSC has no effect on supervisory authorities' powers: it limits neither the substantive scope nor the geographical reach of the power of a supervisory authority.[74] Furthermore, the exception for mandatory rules of public policy in the HSC makes it clear that transaction reporting obligations and similar public law based obligations would not be affected in any event (Article 11).

[69] Goode et al., *Explanatory Report*, 1–35.
[70] EC, *Legal Assessment HSC*, 15; ECB, 'Opinion', 16
[71] ECB, 'Opinion', 16.
[72] See para 10.22.
[73] EC, *Legal Assessment HSC*, 15; Sigman and Bernasconi, 'Myths', 31.
[74] Sigman and Bernasconi, 'Myths', 31.

(d) Diversity of laws in securities settlement systems

10.96 It has also been argued that the HSC would jeopardize the stability of SSSs. Since the HSC allows the choice of law, an SSS and its members could use a variety of laws. Different laws may be applicable to different participants which do not coincide with the law governing the system, and this could destroy the commonality needed for settlement operations within the system.[75]

10.97 The argument is theoretically correct, but not realistic. The system operator and all participants have a shared interest in a smoothly operating system. This makes it highly unlikely that any system operator would agree to different laws among its members.[76] Furthermore, regulatory or supervisory authorities also have the power, if necessary, to compel system operators to ensure that no unacceptable legal or systemic risk can arise from the application of diverse laws. Those authorities may, for example, require that all participants in a national system choose the same law.[77]

(3) The way forward

10.98 It is not easy to predict the future, but it is possible to describe the different alternatives and to weigh up each of them, taking into account their main advantages and drawbacks.

10.99 The simplest option is that the EU ratifies the HSC, an option initially favoured by the European Commission.[78] It would solve the main difficulties associated with the location of the relevant account when different branches are concerned and, therefore, bring more certainty as to which law applies. If need be, the problem of a diversity of laws in EU securities settlement and payment systems could be resolved by amending the definition of 'system' or by imposing an obligation on all participants to choose the same law. Naturally, this would also call for the amendment of EU directives so as to remove the location of the account formula as a connecting factor. At this stage, however, this option seems remote since there does not appear to be sufficient support for the ratification of the HSC, either in the Council or the European Parliament or the ECB.[79]

10.100 The other option is to keep the current EU PRIMA rule, extending it to all uses of securities and refining its application to ensure that it is implemented in the same way in all EU Member States. In addition, other solutions could be explored to put

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[75] EC, *Legal Assessment HSC*, 17; European Parliament Resolution, 14; Ooi, 'Critical Reading', 471; Ooi, 'Intermediated Securities', 233.

[76] EC, *Legal Assessment HSC*, 18; Rank, W., *Assessment: Does the Hague Securities Convention Offer Greater Certainty in International Securities Transactions?* (on file with the authors), 18.

[77] EC, *Legal Assessment HSC*, 18; Sigman and Bernasconi, 'Myths', 32.

[78] EC, *Legal Assessment HSC*, 23.

[79] The situation is the same as reflected in 2007 by EC, Reflection Paper DG MARKT, 4.

the location of an account beyond doubt, different from the choice of law.[80] The main problem is that this option would not provide an international solution, so uncertainty as to the applicable law would persist in the case of proprietary issues concerning non-EU States. While EU law may be able to provide certainty as to which law applies when all aspects of a dealing in securities are located within the EU, it would still be unclear which law applies in a case where any aspects are related to States outside the EU, at least with regard to States that do not apply the location of the account criteria.[81]

10.101 A third option would be to amend the HSC and partially re-establish the original drafts based on the location of the account as a main connecting factor.[82] This, however, would require the consensus of many States, including The Hague Conference itself. If the reasoning for departing from that original approach were the difficulties in identifying the location of the relevant account in modern global trading, it is not easy to imagine what new arguments could be made to rebut that reasoning.

10.102 Finally, if the EU is not willing to change its views, a fourth option would be to have a 'dual-system approach' worldwide—one based on the location of the account (current EU PRIMA rule with additional clarifications) and another based on the choice of law by the parties (HSC rule). The application of either approach would be determined by each intermediary. If the securities are held with an EU intermediary, the first system applies. If the securities are held with a non-EU intermediary, the second system applies. In fact, this is currently the (de facto) status quo. It is not clear whether the current version of the HSC allows for this option, ie, whether the EU could ratify the HSC but excluding the choice of law for EU intermediaries.[83] If this dual-system approach were acceptable, the ambiguity could be resolved by a minor amendment to the current text of the HSC (or by other mechanisms such as a declaration by the Secretary General of The Hague Conference or a Special Commission).

[80] For example, adopting a securities account code which includes a reference to a State; see EC, Reflection Paper DG MARKT, 5.

[81] EC, *Legal Assessment HSC*, 22.

[82] See para 10.10.

[83] For some authors, the answer is clearly positive. See Sigman and Bernasconi, 'Myths', 31, who argue that the HSC does not prevent Contracting States from prohibiting intermediaries 'from choosing any governing law'. It is, nevertheless, at least doubtful whether such a radical and absolute prohibition would not contravene the '*effect utile*' of the Convention.

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United Kingdom

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First Edition published in 2014
Impression: 1

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Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America

British Library Cataloguing in Publication Data
Data available

Library of Congress Control Number: 2013953306

ISBN 978–0–19–967786–3

Printed and bound by
CPI Group (UK) Ltd, Croydon, CR0 4YY

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TRANSNATIONAL SECURITIES LAW

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