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NOTE

from :	European Central Bank
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to :	the Chairman of the Committee on Civil Law Matters (General Questions)
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Subject :	The Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary

I would like to thank you for your letter of 26 January 2003, in which you have invited the ECB Legal Services to provide further information relating to the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary (the "Convention"). We appreciate to have been given such opportunity and would like to confer to you a number of issues, which the Civil Law Committee might wish to consider before taking a final stance in respect of the Convention.

We would like to point out again the ECB's statutory interest in the subject matter, given its potential impact on the stability of the EU financial system in general and more specifically on the legal and operational soundness of the framework supporting the Eurosystem collateralised operations in the field of monetary policy and payment systems, all of which are tasks attributed to the Eurosystem by Article 105 of the EC Treaty. To give an idea of its importance, the daily average of collateral taken by the Eurosystem in 2003 was of around euro 690 billion, of which some 28 % is taken on a cross-border basis.

In our view, an ex ante assessment of the possible implications both as regards Community law and national law in EU Member States should be undertaken in order to avoid undesired and unforeseen effects when the Convention is implemented within the EU. More specifically, it is most crucial that any changes triggered by the Convention shall by no means compromise the current level of legal certainty and protection against systemic risk offered by the existing Community law rules.

Such assessment so far has not taken place. As the signing of the Convention entails certain self-constraints for the Community, such analysis (involving the ECB) should take place before the Decision to sign the Convention is taken. This holds true even more as there is no need for immediate action to sign the Convention and the current legal framework in the EU provides for clarity and certainty and is therefore legally sound.

It is recalled that the Convention determines the choice of law applying to rights resulting from dispositions of securities held with an intermediary. It was initially aimed at implementing the so-called PRIMA[1] approach, according to which the relevant factor to determine the applicable law is the place where the relevant securities account is maintained. It should be noted that this same rule is the state-of-the-art in the EU following Article 9.2 of the Settlement Finality Directive and Article 9.1 of the Collateral Directive. This construction is legally sound and is working without problem. However, the final text of the Convention applies a different principle, namely that the parties to an account agreement can agree on the law of a state, provided that the custodian has an office in such state, which is engaged in the business of maintaining (any) securities accounts (irrespective of whether the specific securities account in question is indeed maintained at that place) for the law of that place to be a valid choice. Such chosen law governs proprietary rights (rights in rem) and has effects on third parties and jurisdictional consequences. This means that an intermediary needs to conduct certain activities related to the maintenance of securities accounts in general (but without necessarily requiring the actual account in question being actually maintained in the jurisdiction chosen). This relates basically to a (limited) contractual choice of law by the parties to a custody arrangement, without any link to the actual location of the securities account. Moreover, such choice may even change by subsequent agreement between intermediary and account holder.

1 Place of the Relevant Intermediary's Account.

The ECB Legal Services maintain their opinion that the approach taken by the Convention is fundamentally different from the one contained in existing Community legislation (i.e. Article 9(2) of the Settlement Finality Directive[1], Article 9 of the Collateral Directive[2] and Article 24 of the Winding-up Directive for credit institutions). The main difference to the Convention stems from the fact that the aforementioned Community legal acts refer to the actual location of a register or a securities account in question, which normally coincides, in securities held through securities settlement systems, with the law applying to the system. The Convention refers, contrary to that, to the governing law as agreed from time to time by the parties, irrespective of whether the actual securities account is actually maintained at that place. Insofar as the location of securities (accounts) is determined exclusively by purely objective criteria (e.g. as in the Settlement Finality Directive for the purpose of security settlement systems), this leaves no room for agreement of the parties. To the extent that parties could agree on the place where a securities account is maintained, such agreement needs to be supported by "*reality*" (i.e. that a securities account is actually maintained at the place so agreed), which can be tested by courts. Thus, any implementation of the Convention entails a need to a prior change to the cited Community legislation and requires subsequent changes to existing legal documentation and practice.

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1 Article 9.2 of the Directive 98/26/EC on settlement finality in payment and securities settlement systems reads: "Where securities (including rights in securities are provided as collateral 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 a 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 holder of collateral security in relation to those securities shall be governed by the law of that Member State.".

2 Article 9.1 of the Directive 2002/47/EC on financial collateral arrangements reads: "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 ECB supports the general considerations that have triggered the work on the Convention, i.e. the extension of the PRIMA approach to the whole world, achieving of ex ante certainty for cross-border securities transactions at the international level. However, the ECB believes that the Convention has deviated from the PRIMA approach and, once ratified by the Community and the Member States, will require substantial adaptations with regard to Community law and national legislation in the field of securities and deposit laws (in particular the Settlement Finality Directive and the Collateral Directive), to the applicable regulatory framework (for example the ESCB-CESR standards for securities settlement systems), and to the Eurosystem collateral legal framework.

Thus, we would like to draw your attention to the potential implications of this Convention:

1. It is noted that the main argument in favour of the Convention is its alleged promotion of ex-ante legal certainty. However, the Convention is the result of compromise and is written with imprecise terminology, not in conformity with either Community or EU national securities legislation. Many provisions require interpretation and differences of interpretation regarding quite a number of aspects have already been voiced (e.g. regarding the scope of the Convention, see further below).

   The Convention also contains gaps. For example, it is stated that the applicable law is determined by the account agreement between an investor and its intermediary. Yet, the Convention does not specify whether in a disposition of securities, it is the law agreed in account agreement of the transferor and its intermediary or the one between the transferee and its intermediary that is the decisive one to determine any rights in respect of securities as determined by Article 2.1 of the Convention and whether or not a transfer of rights has taken place. As opposed to the Convention, the current provisions contained in the Collateral Directive clearly determine the relevant law (cf. Article 9 read in conjunction with Article 2(1)(h)).

We note that some of these problems as well as the reasons underlying some of the compromise wording in the Convention might be addressed in the expected Explanatory Memorandum that is currently under preparation by the Secretariat of the Hague Conference. In fact in some Member States such a memorandum will be relevant to determining the actual meaning of the Convention. It might therefore be premature that the Commission has proposed that the Convention be signed, before the necessary explanations of its meaning have been made available. Of greater concern, if it arises, is whether there may be ambiguities in the text of the Convention that are *not* resolved by the explanatory memorandum. It is hard to see how the Convention can safely be integrated into the Community acquis without an ex ante view of what uncertainties remain and whether they need to be resolved by appropriate legislative implementation.

2. The regime established by the Convention is not transparent. According to the Convention, the law governing rights in securities will be determined by the bilateral (usually non-public) agreement between an intermediary and its customer (which –in addition- could be changed at any time).

   Consequently indeed, for an account holder and his respective intermediary, there is immediate ex ante certainty on the applicable law. However, the opposite party to a securities disposition will be in a far less certain position, as it would have to rely on the information given to him by its counterparty or the latter's intermediary on the content of their custody agreement. Without such information, after having abolished any objective criteria provided by the current conflicts of law rules, there will be no possibility to determine the law applicable to such securities transaction and its validity. Legal certainty regarding proprietary rights will thus be reduced, and the same occurs for jurisdictional rules.

Whilst a party to a disposition of securities could at least contractually oblige the counterparty in the contractual arrangements underlying the transaction to provide such information, for any other third party, wishing to assert competing rights in respect of specific securities, it will be far more difficult to obtain the necessary information. There will be no independent and objective means to do so. These third parties could only ascertain the applicable law, if the intermediary or the account holder would disclose to those third parties which law has been agreed in respect of a specific securities accounts held for a customer. It is also noted that such disclosure might conflict with existing rules on banking secrecy, unless there would be a statutory obligation on intermediary to disclose such information. The choice of the applicable law has also effects on third party creditors (or public institutions seeking to calculate taxes or seize or freeze securities) filing and enforcing an attachment in respect of securities held on an account.

As a consequence, the Convention, by allowing entities to bilaterally agree on the law applicable in particular to proprietary rights in securities, might compromise the position of third parties to those *in rem* issues. This could be seen as being inconsistent to the assumption that proprietary rights are specific rights, which are enforceable vis-à-vis everybody (*erga omnes* effect or rights *in rem*).

3. It is acknowledged that the stated aim of the draft Convention is to harmonise private international law only, and indeed nothing wider than this is within the competence of the Hague Conference. Nonetheless, it appears that the draft Convention would have tangential effects on substantive securities and deposit laws.

   This is because the Convention is founded on a number of untested assumptions, such as that in the course of a securities transaction, a contractual right (a right *in personam*) of a securities' provider may be assimilated to a right *in rem* of the securities' receiver and vice versa without unforeseen side-effects or that every jurisdiction in a chain of securities' intermediaries will come to the same characterisation of the investor's right in the securities.

The Convention is mainly designed for systems of tiered holding of securities, where a legal relationship only exists between an intermediary and its customer (as it is the case in the US model). For those legal systems which have not adopted a uniform regime of interests in securities which resembles the 'securities entitlement' approach of the revised Article 8 Uniform Commercial Code (UCC) in the USA, these assumptions could cause a blurring of the traditional borderlines between purely contractual rights and rights *in rem*. In the former case the law applicable to a securities transaction will be determined between every two members of the intermediaries' transaction chain. In the latter case, many jurisdictions consider the disposition of securities to be a single act, with direct property rights only existing between the highest tier in the chain of holdings and the intermediary. It is unclear what would happen when different jurisdictions involved in the chain of intermediaries come to different conclusions with respect to legal nature of the interest in the securities. The Convention leaves the characterisation to the respective national laws. Such a situation, which does not seem to be impossible at all, might result in confusion and legal uncertainty.

Any such approximation of contractual and property rights is likely to invigorate the current debate on the need to adapt uniform substantive securities laws. It may be recalled that the private international law provision in Article 8 UCC forms only one small part of a far larger code of law designed to eliminate uncertainties by providing a comprehensive legal structure for current securities holding practices.

In particular, those countries might suffer a competitive disadvantage, where traditionally the ownership in the securities is transferred directly and exclusively between the two parties of a transaction, whereby the intermediaries merely transfer possession over the securities or transact simple bookings. Therefore, from an EU point of view, it may be worth considering whether the private international law rule proposed in the Convention should only be implemented together with a substantive law reform (for example as being called for by the Commission's Giovannini Group in its second report on clearing and settlement under the notion 'EU securities account certainty project')

We understand that, if this reform is to proceed, it would be preceded by exactly the kind of deep and wide-ranging analysis of national legal systems and needs that would satisfy the requirement for an ex ante assessment of the possible implications both as regards Community law and national law in EU Member States. There may therefore be some merit in establishing whether that project is to proceed and, if so, whether its scope could be widened without disruption to accommodate this ex ante assessment, thus avoiding duplication of effort and expertise.

4. A further problem stems from the differences in understanding of what an account is. Under common law systems, a securities account is merely a written evidence of a contractual relationship. Consequently, the core of what is evidenced by an account is the determination of the subject matter of obligations as to safekeeping and delivery of securities between the custodian and a client. So, under a common law understanding, to subject those obligations to a choice of law seems uncontroversial (although it is still an innovation that the choice of law applicable to those obligations should also determine the nature of the subject matter of the obligations). However, under civil law jurisdictions, the account is not just a mere recording of the obligations of a custodian vis-à-vis his client, but to enter securities on an account constitutes the fulfilment of an obligation to deliver securities, thus having a direct proprietary effect. Moreover, in a number of legal systems, the maintenance of securities accounts with a securities settlement system or central securities depository is constituted by a (partly) public order regime, designed to ensure the legal stability of the securities custody and settlement. So by submitting that relationship to a choice of law it is not just a matter of freedom of contract but of altering national legal regimes.

5. The scope of the Convention is not entirely clear. Article 2.1(a) states that the law determined in accordance with the Convention defines the nature of the right of the account holder in respect of securities held with an intermediary. It is also supposed to govern third-party effects of the disposition of securities to or the holding of securities on such securities account.

However, the wording of the Convention does not provide a clear distinction between Article 2.1 and Article 2.3. According to Article 2.3(a), the Convention does not determine the law applicable to purely contractual rights and duties arising from the credit of securities to a securities account. It remains unclear whether the application of the Convention is excluded with respect to rights of the account holder against his intermediary which are explicitly related to the securities credited to the securities account and which have been characterised in accordance with Article 2.1(a) of the Convention as being contractual. These gives raise to uncertainties whether the Convention applies to purely contractual rights of an account holder against its intermediary to deliver certain securities (such as e.g. the German concept of *Wertpapierrechnung*).

Yet, if one were to interpret the Convention as applying also to purely contractual rights in securities, such application could conflict with existing private international law rules on the treatment of contractual obligations (i.e. Article 12 of the Rome Convention). In the case of the Rome Convention it is therefore fundamental to distinguish which rights of a contractual nature would not be encompassed by the Convention. A case-by-case analysis of these issues, whereby the various types of rights would have to be examined could run counter to the intention of achieving ex ante certainty on the applicable law.

To the extent that there is an overlap with the Rome Convention, Article 4 of the Convention would come to different conclusions than Article 12 of the Rome Convention. The choice of the law applicable to securities transactions according to the Convention is in the hand of the parties to the custody agreement and not of the parties to the transaction as it is with respect to the Rome Convention. Secondly, according to the Convention, the general contractual rights arising out of the custody agreement might be governed by the law of a different jurisdiction than the one of the contractual rights regarding the holding and transfer of securities. As opposed to this, according to the Rome Convention, the law applicable to the transfer of a contractual right follows mandatory the law applicable to the contract itself. Moreover, the choice of the parties under the Rome Convention does not entail any limitations like the “reality test” in the Convention.

6. So far there has been no assessment of the practical impact of the possibility under Article 1.5 for some central securities depositories and security settlement systems to be opted out. Generally speaking, this could lead to distortions and be detrimental to the goal of creating a universal rule. This holds true in particular for those systems which act at the same time as a direct and an indirect holding system (like some of the Nordic systems) or which act both as a national and a foreign SSS (e.g. in the case of CREST). It also would merit further investigation how such structure would relate to the designation regime established by the Settlement Finality Directive.

7. A number of terms used by the Convention are either defined differently from current Community law usage or are not defined at all. For example, the definition of "*securities*" extends to all kinds of financial instruments and assets or any interest therein. This may include OTC derivative contracts, bills of exchange, cheques or commodities, as it does not seem to be impossible that any of those might be credited to a securities account.

   Furthermore, the Convention is basing the application of the so-called reality test in Article 4 to an intermediary's function of being 'engaged in a business or other regular activity of maintaining securities accounts'. In the EU, there is no straightforward general definition of "*maintenance of securities accounts*" in existing legislation. Only in some countries, the principle is enshrined in law. To the extent that there is no legal definition of "*maintenance of a securities account*", it is likely that a set of legal and factual criteria is used in order to determine where a securities' account is maintained. In particular, the term "*maintenance*" seems to imply that certain functions need to be performed in a certain place. If such functions are not being performed in the agreed jurisdiction, it is possible that a court would characterise such a contractual determination as a "sham" that did not record the true intention of the parties. Such uncertainty could be avoided by establishing a uniform EU concept of "*maintenance of a securities account*", for example by appropriate transposition of the Convention into Community law.

8. So far, the discussion of the Convention was limited to questions regarding the law applying to proprietary and contractual rights in securities. The Convention will also affect jurisdictional issues: the "location" of a securities account will not anymore be where such account really is, but where the intermediary and the accountholder will agree from time to time (under the proviso that the choice is restricted to jurisdictions where the intermediary has an office). Such location determines the competent jurisdiction for actions *in rem*, which therefore becomes dependent on the agreement by the parties to the account at any given moment. It is not clear what effects the Convention will have on the existing rules regarding insolvency, tax, accounting and regulatory aspects.

   Historically, there was a logical connection between a specific custodian activity (maintaining of securities accounts) pursued at a certain location and the applicable law regarding proprietary, insolvency, tax or accounting aspects of securities being subject to such custodian activity. This is of particular relevance for those countries applying the principle of the "unity of the account". Under the Convention's principles, different jurisdictions might govern the proprietary, insolvency, regulatory, tax or accounting aspects of one and the same securities held on an account.

9. Article 8 of the Convention is dealing with the interrelation with insolvency aspects. Article 8.1 stipulates that 'notwithstanding the opening of an insolvency proceeding', the law determined by the Convention shall govern the issues covered by Article 4 or Article 5 in connection with Article 2.1 of the Convention.

   It should be assessed how this provision would interact with Article 8 of the Settlement Finality Directive (and the respective national implementations by the EU Member States). Article 8 of the Settlement Finality Directive states that in the event of insolvency proceedings being opened against a participant in a system, the rights and obligations arising from, or in connection with, the participation of the participant shall be determined only by the law governing that system. This rule ensures legal safety and absence of systemic risk in respect of systems will not be compromised.

A conflict between Article 8 of the Settlement Finality Directive (and the respective national implementations) and Article 8 of the Convention might arise, if the law agreed between a system and its participant to govern rights in respect of securities held on a securities account would not coincide with the law governing the system in accordance with the Settlement Finality Directive.

Further investigation might also be required to assess the impact of a change to the custody agreement (provided that the intermediary has an office in the newly agreed jurisdiction meeting the criteria of Article 4), by which the parties to the agreement would change the applicable law to a securities account. It cannot be ruled out, that in some countries, an insolvency court or liquidator will challenge the effects of such a change to a custody agreement, if the change occurs during a suspect period and holds true in so far as there are no material or objective effects justifying the maintenance of a securities account in a specific jurisdiction. In some countries, a receiver might challenge a change to a custody agreement, if the bankruptcy estate is reduced by the transfer of assets from one jurisdiction to another.

10. It is acknowledged that it is not the aim of the Convention to interfere with matters of tax law. However, by attributing that the law determined by the Convention would also extend to entitlements to dividends income, the distribution or redemption, sale or other proceeds, the Convention could have factual consequences as to the determination of the relevant jurisdiction for the tax effects of such disposition of securities.

11. Furthermore, the potential impact of the Convention on the operation of systems and settlement finality requires close attention.
The approach in the Hague Convention will provide clear benefits for the structuring of operations of custodian banks and broker dealers at a regional or global level. It gives these institutions the flexibility and a certain ex-ante certainty required to customise their securities transactions.

    However, for securities settlement systems and in particular central securities depositories, the introduction of such flexibility might create or increase legal uncertainty and give rise to potential conflicts of law. These do not currently exist for those systems protected by the Settlement Finality Directive.

The main concern that should be analysed is whether by allowing the parties to determine the law applicable to rights in securities (including their disposition), it will be possible that within a system, more than one jurisdiction will govern those rights, depending on each individual account agreement. If these jurisdictions are not harmonised, this may distort the finality of settlement, as according to the Convention the law governing the rights in securities also determines their dispositions and thus ultimately the finality of securities transfers. Thus, different moments in time for transactions to be final or different concepts of finality might be established within one and the same system. This could endanger the soundness of the whole system, in particular in those instances where an agreed law is not covered by a protection comparable to the one granted by the Settlement Finality Directive.

Moreover, there may be a risk that collateralisation techniques, which are used and are legally valid in the country of the location of the SSS are not valid under the chosen legal system. As a consequence, a credit may end up as being uncollateralised. In a worst case scenario, and depending on the circumstances of the particular case, this may lead to a domino effect.

Furthermore, the impact of the application of the principles of the Convention on the exercise of oversight and financial stability functions by the competent authorities might merit a close scrutiny.

Taking into account the pivotal role of the smooth functioning of settlement systems for the Eurosystem collateral framework in particular, and financial stability at large, it has to be ensured that the changes triggered by the Convention will be implemented without compromising the current level of protection (e.g. by adequate modifications to the Community directives or the CESR-ESCB standards).

These considerations might require, *inter alia*, a limitation of the choice of law applying to rights in respect of securities held on accounts with a systemically important system (in particular securities settlement systems evaluated and used by the Eurosystem) to the law governing that system, as well as other measures designed to safeguard systemic finality, certainty and transparency. These considerations have already been expressed by the ECB in its opinion of 26 June 2003 at the request of the Austrian Federal Ministry of Justice on a draft Federal law implementing Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (CON/2003/11, published on the ECB web site www.ecb.int).

If there is just one law applying to rights in respect of securities held on accounts with a systemically important system, any party could know in advance the law applying to the holding of transfer of rights in securities held with such a system and the risk of a lack of interoperability of more than one relevant jurisdictions would be omitted. Conflicts of laws, as well as systemic risk would be minimised under such set-up.

12. Another aspect that might deserve further consideration is the effect of the Convention on existing standard documentation. It is not unlikely that the Convention, by introducing a completely new legal concept, will require changes in standard documentation used by the European financial and securities industry (whereas it is likely that only few changes will be required for the US industry). This applies in particular to standard custody agreements, as well as to collateral arrangements and the contractual documentation used by systems.

Whilst this could be accommodated by appropriate changes in newly concluded agreements, the effects on existing contracts might be more difficult (and more costly) to assess. The transition provisions contained in Articles 15 and 16 are worded in a rather complicated manner. It might be necessary to investigate for each individual existing agreement, as to which result would stem from the application of the Convention principles. Given that Article 16 is introducing interpretation rules with generally retroactive effect, due diligence will require custodians and investors to check all existing account agreements to verify whether the originally applicable law to rights held on securities accounts will be altered by the Convention and, if necessary, take remedial measures.

Particular attention might be required to ascertain that the Convention will not result in the loss of previously well-established (ownership) rights, as this could have constitutional implications in some Member States regarding the protection of property.

13. Finally, the impact of the Convention on the consolidation of trading and settlement activities at a global and regional level and the possible migration of custody business should also be considered. Although concentration of these activities does not necessarily give rise to problems, concentration outside the EU might be a source of concern for the competent authorities' exercise of oversight and financial stability functions.

    One of the potential developments fostered by the ratification of this Convention could be the further expansion of the use of a non-EU (e.g. New York) law in financial transactions and related standard market documentation. The Convention would allow the choice of these jurisdictions in situations where currently this would not be possible (e.g. for proprietary rights in securities held on accounts inside the EU). The US global market players are quite often in a dominant situation and could impose their domestic law to market participants. Inter alia, the EU should not go ahead with the signing and ratification of the Convention before the US has proceeded; otherwise the 'migration' towards US law could take place in Europe's securities markets, whilst the opportunities for a reciprocal move will be slim.

Having regard to the above mentioned considerations and given the lack of certainty about the possible implications, we urge that a comprehensive impact analysis is undertaken in advance of the signing of the Convention. This holds even more true as the signing of the Convention would bind the signing parties even in case that an ex-post assessment would prove negative implications for the financial stability e.g. of systemically important systems in the EU.

According to the above stated, in order to be ratified by the Community and the Member States, prior adaptations will be required with regard to Community law (in particular the Settlement Finality Directive, the Financial Collateral Directive and the Winding-up Directive for credit institutions). Certain provisions of the Convention will also directly affect the Eurosystem monetary policy framework (in particular its collateral policy) and the respective implementing measures in the documentation of national central banks.

Furthermore, as shown by the above comments, given the extent of complexities and uncertainties resulting from the wording of the Convention, the Convention should be implemented by an adequate transposition into clear and unambiguous language in the *acquis communautaire*, ideally together with an addressing of the substantive law aspects, as advocated by the EU securities account certainty project. Only by virtue of such an implementation technique, possible interference with other Community law provisions can be avoided and the original aim of achieving ex-ante certainty not only *inter partes* but also *erga omnes* can be achieved.

We might add one final point. We are well aware that the text of the convention was settled in December 2002 by the unanimous representation of all 15 EU Member States and that the Commission duly acceded to the common view. However, as explained above, the ECB has a legal duty arising from the EU Treaty to consider issues relating to the legal infrastructure of the Union from a specific perspective. It may well be that there are advantages of flexibility in the reform to the law that the Convention represents. The ECB, however, had a duty to consider the EU financial markets *as a whole*, and to give as much weight to matters of stability as to those of market convenience. For the reasons stated above, the impact of the Convention on the stability of the financial system remains far from clear.

In line with the letter of, the President of the ECB s to the President of the European Commission, Mr Prodi, dated 20 February 2003, the ECB Legal Services stands ready to provide any assistance that might be deemed helpful. in these complex matters.

Again, I trust that these considerations are being of help for the work of the Civil Law Committee and we stand ready to provide further information, if required.

(Complimentary close)

[signed]
Antonio Sáinz de Vicuña
General Counsel