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THE HAGUE CONVENTION OF 5 JULY 2006 ON THE LAW APPLICABLE TO CERTAIN RIGHTS IN RESPECT OF SECURITIES HELD WITH AN INTERMEDIARY *(HAGUE SECURITIES CONVENTION)*

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I. Introduction [1]

The need for uniform conflict of laws rules that effectively address the reality of how securities are held and transferred[2] today (*i.e.*, by electronic book-entry debits and credits to securities accounts of primarily dematerialised or immobilised securities) has become critical. The last several decades have seen a dramatic increase in the value, number and speed of cross-border securities transactions, facilitated by advances in technology. The value of trades and collateral transactions in OECD (Organisation for Economic Co-operation and Development) government and corporate securities, for example, has grown to approximately US$ 2 trillion per day.[3] Legal uncertainty as to the law governing the perfection, priority and other effects of transfers imposes significant friction costs on even routine transactions and

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The following contribution is a slightly revised and updated version of an article co-authored by Christophe Bernasconi & Harry Sigman and which was published in the Uniform Law Review 2005-1/2, pp. 117-140, Special Volume entitled "Enhancing Legal Certainty over Investment Securities Held with an Intermediary" (see http://www.unidroit.org/english/publications/review/main.htm). This updated version was completed on 9 February 2007; all the websites referred to in this article were last visited on that date.

[1] The text of the Hague Securities Convention is available on the HCCH website (www.hcch.net), under the headings "Welcome" -> "Conventions/All Convention" -> "36" (http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72). A two-page outline of the Convention may be found on the same page of the HCCH website. The Explanatory Report of the Convention was prepared by Professor Roy Goode (United Kingdom), Professor Hideki Kanda (Japan), Professor Karl Kreuzer (Germany), with the assistance of Dr Christophe Bernasconi (Permanent Bureau). A commercial edition of the Explanatory Report may be ordered via the HCCH website. Both the Convention and the Report have been prepared in the two official languages of the HCCH (English and French).

[2] In this article, unless otherwise indicated, "transfer" includes an outright transfer of ownership, a transfer by way of security, and the grant of a security interest, pledge or other form of hypothecation; see also Art. 1(1)(h) of the Convention.

[3] See Explanatory Report, *supra* note 1, para. Int-2.

operates as an important constraint on desirable reductions in credit and liquidity exposures. Increased exposure to unsecured credit risk amplifies systemic risk and the potential proliferation of bankruptcies. Not surprisingly, the international legal and financial community has been emphasising, for more than a decade, the need for uniform conflict of laws rules applicable to transactions involving securities held with intermediaries.[4]

To address the current uncertainties, the 19th Diplomatic Session of the Hague Conference on Private International Law (HCCH) unanimously adopted the *Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary* (the "Hague Securities Convention" or the "Convention").[5] Key industry groups such as the Group of 30 (G30) promptly urged its immediate and universal ratification.[6] Such reactions reflect the importance of the Convention,

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4 See in particular: Euroclear, *Cross-Border Clearance, Settlement and Custody: Beyond the G30 Recommendations*, Brussels 1993, p. 62; Randall Guynn, *Modernizing Legal Rules to Reduce Settlement Risk*, 1 Capital Markets Forum Yearbook, IBA 1993, pp. 172-179; *ibid.*, *Modernizing Securities Ownership, Transfer and Pledging Laws*, A Discussion Paper on the Need for International Harmonization, with Responding Comments by Professor James Steven Rogers (United States), Professor Kazuaki Sono (Japan) and Dr Jürgen Than (Germany), Capital Markets Forum, Section on Business Law, IBA 1996 (paper available in pdf format on the Internet at http://www.dpw.com/iba.modernization.pdf); for more references, see Explanatory Report, *supra* note 1, footnote 3.

5 According to the tradition still followed by the HCCH at that time, the 19th Session in fact adopted a *draft* Convention; it was only on 5 July 2006, *i.e.*, on the day of the signing by Switzerland and the United States of America, that the draft became a *Convention*. One should thus speak of the Convention of 5 July 2006. It is recalled that under Art. 19 of the Convention, the entry into force of the instrument necessitates the ratification, acceptance, approval or accession by at least three States. The tradition according to which a Hague Convention bears the date of its first signing was abandoned (rightly, in our view) with the *Convention on Choice of Court Agreements*, which bears the date of its adoption by the Diplomatic Session (30 June 2005).

6 Group of Thirty (G30), *Global Clearing and Settlement – A plan of action*, January 2003 (see http://www.group30.org/recommendations.php). Recommendation 15 of this Report addresses the need to advance legal certainty "over rights to securities, cash, or collateral"; the commentary on this Recommendation stresses that "[o]ne area of recommendation for which united support can be offered is choice of laws. National authorities should be encouraged by all interested parties to sign and ratify the just-adopted Hague Convention as soon as reasonably possible. It is of course critical to its effectiveness that the Hague Convention be ratified as quickly as possible in as many nations as possible." See also G30, *Global Clearing and Settlement – Final Monitoring Report*, Washington 2006 (http://www.group30.org/recommendations.php). Appendix 3 of this 2006 Report (p. 33 *et seq.*) provides a summary of the work conducted by the Legal Subcommittee of the G30 (of which the author of this article was a member), an overview of the Convention as well as the status of the implementation of the Convention in 15 target jurisdictions selected by the G30. As regards the status of implementation in the EU-Member States, the Report emphasises that "the choice-of-law rules in the Hague Convention are broader in scope [than the scope of the rules in the relevant instruments of the European Community] and so remain an important goal." On the limits of the solution adopted in the relevant EC instruments, see in particular Jean-Pierre Deguée / Diego Devos, *La loi applicable aux titres intermédiés: l'apport de la Convention de La Haye de décembre 2002*, Revue de Droit Commercial Belge / Tijdschrift voor Belgisch Handelsrecht 2006/1, pp. 5 *et seq.*, in particular paras. 9-12 ; Harry C. Sigman / Christophe Bernasconi, *Myths about the Hague Convention debunked*, International Financial Law Review, November 2005, pp. 31 *et seq.*, in particular pp. 32 and 33 [Myth three: The Convention would displace an existing successful European PIL regime]. On the evaluation of current EC regime, see also *infra* note 20 and accompanying text. For the position of ISDA (International Swaps and Derivatives Association), another highly important industry group, see www.isda.org (under the headings "Comment Letters, Policy Papers & Statements" -> "Submissions dated 2005" (02/28/2005: "ISDA comments on ECMI project on the potential impact of the Hague Securities Convention"), "Submissions dated 2004" (07/26/2004: "The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary"), and "Press" -> "Press Releases 2006" (July 5, 2006: "ISDA Welcomes U.S., Swiss Signature of Hague Securities Convention").

constitute a strong sign of its macro-economic relevance, and prefigure the key role it will play in the safe, sound and effective functioning of national financial systems, as well as individual private transactions. The Convention's importance was also promptly recognised in scholarly writings.[7] Soon after its adoption, several governments, as well as the relevant bodies of the European Community, started the necessary consultations regarding a possible signing and ratification of the Convention. To date, the Convention has been signed by the USA and Switzerland;[8] both these States are actively working towards the ratification of the Convention.[9] In other States, as well as at the level of the European Community,[10] the assessment of the Convention is ongoing.[11] In this respect, it should be noted that the process leading to the adoption of the Convention was quite unusual, and in many respects remarkable: it was negotiated, in a totally inclusive and transparent fast-track procedure that lasted only thirty months (May 2000 to December 2002), by delegations from around the world (31 Member States of the Hague Conference, 2 non-Member States, 8 Intergovernmental Organisations, 9 non-Governmental Organisations) – delegations that reflected all major legal systems and that included not only private international law experts, but also experts in securities industry practice and commercial law - with the active participation of important industry representative groups. Thus, the Convention reflects a pragmatic approach, based on real world needs, aimed at achieving *ex ante* certainty and predictability as to the

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7 An updated selection of publications relating to the Convention can be found on www.hcch.net, under "Welcome" -> "Conventions" -> "36" -> "Bibliography". For a robust response to questions raised and criticism made with respect to the Convention, see the comments below under III.A.4.

8 For updated information, see www.hcch.net, under "Welcome" -> "Conventions" -> "36" -> "Status table".

9 See the notice "Swiss Government recommends quick ratification of Hague Securities Convention" on www.hcch.net, under "Welcome" -> "Latest Developments".

10 On the same day as the signing by Switzerland and the USA (5 July 2006), the European Commission released the results of its "[l]egal assessment of certain aspects" of the Convention. The Commission concludes in particular that "adoption of the Convention would be in the best interest of the Community" and recommends that Convention "be signed after or with at least two of its main trading partners, the USA included." In a press release issued on the same day, Internal Market and Services Commissioner McCreevy commented as follows: "In today's global financial markets we can no longer afford uncertainty about which law is applicable to indirectly held securities. The 'location of the account formula' has worked fine in Europe's transition to a fully integrated single securities market, but now that European citizens are able to reap the benefits of participation in global financial markets, we need legal rules that are sustainable world-wide. Therefore, we need to change. The USA and Switzerland are about to sign the Convention and the EU should not lag behind." See the notice "Switzerland and United States sign Hague Securities Convention" on www.hcch.net, under "Welcome" -> "Latest Developments". On 15 December 2003, the *European Commission* had already submitted to the Council a proposal for a Council Decision concerning the signing of the Hague Convention (16292/03 JUSTCIV 273); see also the comments in footnote 19 below. On 14 December 2006, the European Parliament (EP) adopted a "resolution on the implications of signing the Hague Securities Convention" (see http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2006-0608+0+DOC+XML+V0//EN). This resolution includes some rather unexpected comments (such as, under point 7: "ensuring the security of intra-European transactions must take precedence over the facilitation of transactions between the European Union and the rest of the world" – when it is evident that in the field of securities held with an intermediary, no clear-cut distinction can possibly be made between purely intra-EU holding-patterns and other ("rest of the world") holding patterns); on the main shortcomings of this resolution, both in terms of its analysis of today's market reality and of the Hague Securities Convention and the negotiating process that led to it, see also *infra* notes 12, 20, 24, 25, 32, 45 and accompanying text. It should also be noted that the EP was represented during the entire negotiation of the Convention.

11 In Mexico, for example, on 21 September 2006, the board of INDEVAL (Central Securities Depository) formally recommended signing of the Convention. A few weeks later, the Securities Commission of Brazil also recommended signing of the Convention.

law governing issues that are of crucial, practical importance for the holding and transfer of securities held with an intermediary, in particular their effects against the intermediary and third parties.[12]

The *ex ante* legal certainty that the Convention is designed to achieve is very important under the revised capital adequacy framework commonly known as Basel II.[13] This revised framework, which was endorsed in June 2004 by Central Bank Governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries, provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructures. Banks use a number of techniques to mitigate the credit risks to which they are exposed; for instance, by taking collateral in the securities to ensure first priority rights on default. When these techniques meet the requirements for legal certainty established by the Basel II accord, the revised approach to credit risk mitigation allows for the recognition of a wider range of strategies to alleviate credit risk for regulatory capital purposes than is permitted under the 1988 Accord.[14]

This article will briefly describe the changes that have occurred over the last several decades in the way shares, bonds, and other investment securities are held, traded and settled. It will then demonstrate the resulting need for re-examining the traditional conflict of laws rules applicable to transactions involving securities held with intermediaries. The main part of the article will explain the content, operation and principal advantages of the primary conflict of laws rule embodied in the Convention, and will be followed by a discussion of the Convention's most significant other provisions. The article will conclude with a brief overview of the Convention's remaining provisions.

II. Holding and transfer of securities — changes in market practice; the legal environment; conflict of laws issues

A. From direct to indirect holding

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12 In light of the broad, balanced, inclusive and most representative nature of the negotiations of the Convention, it is somewhat puzzling that the EP's resolution (see *supra* note 10) expresses "extreme concern" at some of the solutions adopted by the Convention, that it characterises some of these solutions as "highly inadequate" and that it calls for a "comprehensive impact study" on the implications of an accession to the Convention – more than four years after the completion of the negotiations of the Convention and following the Commission's assessement referred to *supra* in note 10.

13 See Bank for International Settlements, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*, June 2004, available on the website of the Bank for International Settlements (www.bis.org – see in particular http://www.bis.org/publ/bcbsca.htm).

14 The minimum standards for legal documentation that must be met for banks to obtain capital relief for any use of credit risk mitigation techniques are set, in para. 118 of the Basel II framework, as follows: "All documentation used in collateralised transactions and for documenting on balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability."

Over the last half century there has been a marked change in the way that shares, bonds and other investment securities are held and transferred. The two principal changes are (i) the immobilisation or dematerialisation of securities, and (ii) the shift *from* the holding of securities through the registration of ownership on books maintained by or for the issuer or the physical possession of security certificates, without the involvement of any intermediary (*i.e.*, direct holding system whereby there is a direct relationship between the issuer and the holder), *to* holding systems in which interests in securities are held (and transferred) through securities accounts maintained for customers by intermediaries, one or more of which stand between the customer and the issuer (*i.e.*, the owner is said to hold its securities indirectly, because its holding is reflected in an account maintained for it by its intermediary, even though in some legal systems the owner is said nevertheless to have a direct legal relationship with the issuer, and the intermediary is viewed as a mere pass-through record-keeper without any legal interest in the securities held). In indirect holding systems, there will be one or more intermediaries (a term which includes not only Central Securities Depositaries and International Central Securities Depositaries, where large quantities of securities of different issuers are immobilised or otherwise concentrated, but also clearing corporations, central banks, securities firms and banks) positioned between the investor and the issuer. Typically, a CSD or ICSD will maintain securities accounts for financial institutions, broker-dealers and other intermediaries (these account holders are often called 'participants' of the CSD or ICSD). These participants, in turn, maintain securities accounts for their customers, such as institutional investors or other intermediaries. These intermediaries, in turn, maintain securities accounts for other intermediaries, and so forth with the lowest-tier intermediary maintaining a securities account for the ultimate investor. Thus, there may be a variable number of tiers between the investors at the bottom of the structure and the issuers at the top. In many systems, there is no record (*i.e.*, no identification or segregation) of an individual account holder's interest in the underlying securities at the level of the issuer's register or that of any intermediary other than the intermediary with whom the investor has a direct relationship.[15]

B. Substantive law approaches to securities held with an intermediary

Substantive law approaches to the holding of interests in securities with an intermediary vary among legal systems. Under some legal systems, the investor's intermediary[16] is contractually and/or legally obligated to hold interests in securities, corresponding to the investor's interest and to those of the intermediary's other customers, credited to a securities account maintained for it by its intermediary and so on up the chain to the highest-tier intermediary, whose holdings are reflected directly on the issuers' books; thus, in these legal systems, there is a separate interest at the level of each intermediary and the highest-tier intermediary (or its nominee) is the registered holder of the securities on the issuer's books. Under other legal systems, however, an intermediary acts as a mere record keeper of an investor's interest; thus, while the investor's interest results from a credit to a securities account and is transferable through book-entry, the credit of the securities

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[15] This characteristic, however, has nothing to do with regulatory matters or strictly corporate matters such as the right of the ultimate investor to receive notices, attend meetings or vote shares.

[16] The intermediary that maintains a securities account for its customer, regardless of which level that customer may occupy, is referred to in the Convention and in this article as the "relevant intermediary".

to a securities account maintained by the investor's intermediary establishes a direct relationship between the investor and the issuer. Consequently, in these legal systems, no intermediary is registered on the issuer's books as the holder of the securities. Even under the latter legal systems, the investor's interest in the securities is within the Convention since it is held through a securities account maintained for the investor by an intermediary.

C. The conflict of laws analysis

1. The traditional *lex rei sitae*

The traditional rule for determining the enforceability of a transfer of property effected in the direct holding system is the *lex rei sitae* (or the *lex situs*), more specifically referred to in the context of securities as the *lex cartae sitae*. Under this rule, the effectiveness of a transfer of securities is determined by the law of the place where the securities are located at the time of the transfer. In the case of bearer securities (*i.e.*, securities which are represented solely by physical certificates and are not registered in any name), this is taken to be the law of the place of the certificates representing the securities at the time of transfer. In the case of registered securities, the *lex rei sitae* is taken to be either the law of the place of the issuer's incorporation or organisation or the law of the place where the register is maintained (whether by the issuer itself or by a registrar on behalf of the issuer) at the time of transfer.

These traditional approaches have generally produced a satisfactory result in relation to directly held securities. These approaches are, however, unsatisfactory in relation to interests in securities held with an intermediary, as they require, for the purposes of determining the applicable law, 'looking through' tiers of intermediaries to the level of the issuer, register or actual certificates (the 'look-through' approach). Suffice it to say, in the context of securities held with one or more intermediaries, the 'look-through' approach may not be possible at all, and even when possible, may give rise to severe difficulties. In today's markets, it is very common, both for intermediaries providing collateral to their financiers and the CSDs of which they are participants, and for investors providing collateral to their financiers, to hypothecate a diversified portfolio of securities issued by companies organised under the laws of diverse jurisdictions (and/or maintaining registries in diverse jurisdictions) and/or by diverse governments and governmental agencies - a practice facilitated by modern movables security laws. Rules based on a 'look through' approach would compel the collateral taker to determine and satisfy the perfection requirements of the domestic movables security law of each of the States where the issuers of the particular debt or equity securities are organised (or where the registries are maintained): a multitude of States for each such transaction. Moreover, where the portfolio is not static but changes composition over time or even daily or hourly (again, a practice greatly facilitated by modern movables security laws), it is impossible, under such traditional conflict of laws rules, for the collateral taker to efficiently manage a security interest in the portfolio. In addition, in many jurisdictions it is unclear exactly which of the rules based on a 'look through' approach should be applied: the law of the place of the issuer's organisation, the law of the place of the securities register, the law of the place of the underlying security certificates, the law of the place of the highest-tier intermediary or the law of the place of any other intermediary? Finally, even if the collateral taker does know which test to apply, it is often not possible to obtain the information necessary to apply the appropriate test.

For example, an investor holding certificated securities through several tiers of intermediaries may not be able to discover where the certificates are actually stored.

2. The Place of the Relevant Intermediary Approach

Against this background of fundamental difficulties raised by the 'look-through' approach, it was initially suggested that the Convention's conflict of laws rule should, in a continued search for a place, or *rei sitae* (real or fictional), focus on the location of the account to which the interest in the securities is credited, that is, the account maintained by the relevant intermediary, or the location of the office maintaining that account. This concept was described as Place of the Relevant Intermediary Approach (PRIMA). It proposed that, in relation to securities held with an intermediary, the law applicable to the effects against the intermediary and third parties of holdings and transfers of such securities be determined based on the place of the relevant intermediary's office at which the account is maintained, without consideration of the location of any higher-tier intermediary or the issuer or the registry or the security certificate, that is, avoiding 'look-through'.[17]

While this approach would subject all of an account holder's interests with respect to a portfolio of securities to the law of a single jurisdiction, it nevertheless suffers from a fundamental difficulty. In the course of the Convention negotiations it became clear that there is no criterion – generally acceptable on a global basis for all categories of intermediaries and all types of securities falling within the Convention's scope – to determine definitively and beyond a doubt the location of a securities account (an intangible having no real location) or the office of an intermediary which maintains a specific securities account.[18] Among the means and criteria mentioned as possible determinants of the location of an office that maintains a securities account were the use of tax, regulatory reporting or accounting requirements. In certain States, intermediaries may be required to assign a code to each securities account that effectively allocates it to a particular office for tax, regulatory reporting or accounting purposes. However, such tax, regulatory reporting or accounting requirements are by no means universal (indeed, they may be the exception rather than the rule). It is not the case in all States that securities accounts must appear on an intermediary's balance sheet and, in any event, not all States have comprehensive accounting rules for assets and liabilities that do appear on an intermediary's balance sheet. Also, accounting, regulatory, and tax rules are based on considerations that are wholly unrelated to the considerations pertaining to the global business of securities custody, clearing and settlement. Therefore, it was

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[17] PRIMA has been adopted, for example, in the conflict of laws rules contained in Art. 9(2) of the *Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems*, and in Art. 9(1) of the *Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements*. The latter provision reads as follows: "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."

[18] See the Explanatory Report, *supra* note 1, para. Int-41 *et seq*. and 4-3 *et seq*.; Deguée / Devos, *supra* note 6, paras. 11 and 36; James Steven Rogers, *Conflict of Laws for Transactions in Securities Held through Intermediaries*, Cornell International Law Journal 2006 (39), pp. 285-328, available on the Social Science Research Network, SSRN: http://ssrn.com/abstract=815005, see in particular pp. 25 *et seq.* Professor Rogers brings the point home with the help of a few, but very persuasive words: "But there is a problem. An account does not have a location. Period. There is no way around that fact. An account is an abstract legal relationship between two entities. Abstract relationships do not have locations."

found arbitrary to use the allocation of a securities account to a particular office for tax, regulatory reporting or accounting purposes to determine the applicable law for an unrelated business purpose. Moreover, it was found that locating an office as maintaining a particular account would be increasingly impossible in light of the reality that some or all of the functions involved in the maintenance and servicing of a securities account are increasingly being undertaken from more than one office or outsourced to third parties in several locations. In light of the difficulties and uncertainties relating to the effort to "localise" a securities account or the place where it is maintained, it is suggested here that the rules, currently embodied in the European Settlement Finality and Collateral Directives,[19] provide only an illusion of certainty.[20]

In sum, if the Hague Securities Convention's criterion for determining the applicable law had been the location of the securities account or the location of the office where the securities account is maintained, no certainty would have been achieved and such a test would have invited litigation in which courts would be required to make fact-intensive inquiries. The risks and burdens presented to a potential collateral taker are readily apparent. Against this background, it became apparent in the course of the negotiations that the Convention had to move beyond the initial formulation of the PRIMA concept in order to provide the necessary *ex ante* legal certainty and predictability. It did this by abandoning the effort to attribute a "location" to an intermediary, a securities account or an office at which a securities account is maintained, and replacing it with an approach giving effect to an express agreement on governing law between an account holder and its intermediary (including in this approach a Qualifying Office requirement, as described below). In so doing, the Convention adhered to the agreed rejection of rules based on *lex rei sitae* or any 'look-through' approach, and it retained the key element of the relevant intermediary by focusing on the relationship between an account holder and the relevant intermediary with respect to a particular securities account.

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19 See *supra* note 17.

20 See in this respect the comment by Rogers, *supra* note 18, p. 27: "The annoying reality is that abstract relations simply do not have a location. Thus, at present, the law in the European Union is stuck in the situation of having adopted a conflict of laws rule that those who have examined the matter carefully have determined simply will not work". This, in essence, also seems to be the conclusion of the Commission's evaluation of Art. 9 of the Collateral Directive, when it states: "Therefore, also in the event that the Council would decide not to go forward with the [Hague] Convention, Article 9 FCD (as well as Article 9 SFD and Article 24 Winding-up Directive) would still have to be amended to improve the situation within the Community by specifying the exact criteria for determining the relevant location of account. The example of the two Member States (France and Portugal), that have developed such criteria, shows that different interpretations are indeed possible", see *Report from the Commission to the Council and the European Parliament – Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC)*, COM(2006)833 final – under heading 4.5.). See already the *Communication from the Commission to the Council and the European Parliament - Clearing and Settlement in the European Union - The way forward,* issued in April 2004 (COM/2004/0312 final), which at least implicitly endorses this view which is to be welcomed and strongly supported: "The implementation of the Hague Convention in the EU will enable participants to determine in advance of any action, with certainty and with only reasonable effort what national substantive law governs their rights to indirectly-held securities. In the context of its responsibilities, the Commission will make the necessary arrangements for the signature and subsequent accession to the Convention by the European Union and its ratification by the Member States. The Commission will also take the necessary steps to bring the Settlement Finality and the Financial Collateral Directive in line with the conflicts of law provisions of the Hague Convention" (p. 24 of the Communication). Against this background, the "commitment to the PRIMA principle" expressed by the EP in its resolution (see *supra* note 10) is inconsistent and seems to reflect a misconception of today's market reality.

III. The conflict of laws rules adopted in the Convention (Arts. 4-6)

A. The primary rule (Art. 4): an expressly agreed choice of law, subject to a 'Qualifying Office' requirement

1. The agreed choice of law

Article 4 is the key provision of the Convention. It sets forth the primary conflict of laws rule to determine the law applicable to all the issues falling within the scope of the Convention. The rule is not based on an attempt to 'locate' a securities account, the office at which a securities account is maintained, an intermediary, the issuer, or the underlying securities. Rather, the Convention's primary rule is based on the relationship between an account holder and its intermediary: it gives effect to the express agreement by the parties to an account agreement on the law governing all the issues falling within the scope of the Convention. This choice may be expressed in either of two ways: if the parties expressly agree on a law governing their account agreement (general governing law clause), that law also governs all the issues falling within the scope of the Convention; if, however, the account holder and its relevant intermediary expressly agree that the law of a particular State will govern all the issues falling within the scope of the Convention, that law governs all these issues (whether or not there is also a separate choice of law to govern the account agreement generally).

The requirement that the agreement be "express" makes clear that the Convention will not give such an effect to an implied choice of a law (whether implied from the terms of the account agreement considered as a whole or from the surrounding circumstances or otherwise).[21] Under Article 4(1), only an express agreement will determine the applicable law. That an implied but unexpressed choice could have effect under the Convention, would seriously undermine the certainty and predictability provided by the Convention.[22]

2. The Qualifying Office requirement

The parties' express choice of law, however, will be effective to determine the applicable law under the Convention only if, at the time of the agreement on governing law, the relevant intermediary has an office in the selected State which meets either of two criteria set out in the Convention (the 'Qualifying Office' requirement).

Under the first criterion (Art. 4(1)(a)), the office must be one which, alone or with another office of the intermediary or a third party acting for the relevant intermediary *anywhere* (*i.e.*, in the selected State or in any other State): (i) effects or monitors entries to securities accounts; (ii) administers payments or corporate actions relating to securities held with the intermediary; or (iii) is otherwise engaged

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[21] This is in sharp contrast to the agreement involved in the limited situation referred to in Art. 16(4), final sentence; see the further comments on Art. 16 below in section IV, F.

[22] The term "express" should not be construed as a form requirement, to-wit, that the account agreement must be in writing. Where a writing requirement is intended, the Convention imposes it explicitly (see Art. 5(1)).

in a business or other regular activity of maintaining securities accounts.[23] Under the second criterion, an office is a Qualifying Office if it is identified, by any specific means, as maintaining securities accounts in that State.

It must be stressed that no aspect of the Article 4(1) Qualifying Office requirement relates to any *specific* account maintained by the relevant intermediary or any *specific* account holder. The Qualifying Office need not be related to the securities account in respect of which the issue arises, and an office is a Qualifying Office if it satisfies any of the criteria described above, even if the securities account of the particular account holder in respect of which the issue arises is maintained at an office situated in another State (assuming that one can determine where a particular account is maintained).

The Qualifying Office requirement was inserted out of an abundance of caution to give heightened assurance against abuse, the potential of which was feared by some delegates. In fact, the requirement should rarely cause even a moment's pause. After all, most intermediaries are professional and responsible institutions - typically regulated entities - highly unlikely to enter into governing law agreements for the purpose of abusing a potential third party or to have difficulty satisfying the Qualifying Office requirement both obviously and legitimately.[24]

3. Explanatory rules for transfers by an account holder in favour of its intermediary (Art. 4(3))

Article 4(3) eliminates uncertainty over the issue of which intermediary is the relevant intermediary and which account agreement is the relevant account agreement in the context of a transfer by an account holder in favour of its intermediary, including circumstances when the intermediary holds a corresponding position in the same type and quantity of securities with an upper-tier intermediary, or moves securities from one account to another with the upper-tier intermediary to comply with customer segregation requirements (whether regulatory or contractual). Article 4(3)(a) and (b) confirm that the relevant intermediary is the account holder's intermediary and the relevant account agreement is the account agreement between the account holder and its intermediary for purposes of applying Articles 4(1) and 5(1). Article 4(3)(c) confirms that the securities account to which the securities are credited immediately before the transfer is the relevant securities account for the

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23 The last of these three alternative modes of activity is not satisfied if the actual activity of an office consists *merely* of one of the activities listed in Art. 4(2). Art. 4(2) sets forth a list of activities none of which, standing alone, is sufficient for an office to be considered engaged in a business or other regular activity of maintaining securities accounts within the meaning of Art. 4(1)(a)(iii). The list includes being a place that is engaged solely in representational functions or administrative functions and lacks authority to make any binding decision to enter into any account agreement, unless the functions relate to the opening or maintenance of securities accounts. The list also includes merely being the place where the technology (*e.g.*, computers) supporting the bookkeeping or data processing is located; where a call centre is located; where mailing relating to securities accounts is organised; or where files or archives are located. It is important to stress that none of the listed activities is a disqualification; rather, the list merely sets a bottom line – *any* of these activities *alone* would not constitute the office as being engaged in maintaining securities accounts within the meaning of Art. 4(1)(a)(iii). It is also important to appreciate that Art. 4(2) comes into play only in the context of Art. 4(1)(a)(iii); it has no effect in the context of either Art. 4(1)(a)(i) or (ii), which function independently as safe harbours in satisfying the Qualifying Office requirement.

24 Again, this reality seems to go unnoticed in the EP's resolution (see *supra* note 10), when in point 8 it refers to the "highly inadequate nature of the reality test".

purposes of Article 5(2) and (3). The interpretive rules of Article 4(3) apply whether or not the intermediary maintains on its own records a securities account in its own name to which are credited any securities debited from the account holder's securities account.

4. Appraisal of the primary conflict of laws rule

Article 4(1) reflects a policy decision to formulate a conflict of laws rule that reduces risk, promotes capital formation and investment, reflects existing and foreseeable market practice, is practical and efficient, and permits market participants to determine, in advance, which law governs all the issues falling within the scope of the Convention. Article 4(1) thereby provides *ex ante* legal certainty and predictability for the largest number of transactions. Under current market, legal and regulatory conditions, none of the alternatives considered and rejected would have provided the degree of *ex ante* legal certainty, simplicity, logic and clarity that the rule in Article 4(1) provides.

It should be noted that the Convention's primary conflict of laws rule works equally well in all situations involving securities held with an intermediary, independently of the nature of the right resulting from the credit of securities to a securities account and whether the right is enforceable against the relevant intermediary, any higher tier-intermediary or the issuer.

Some voices in Europe have asserted that the possibility for the operator of a securities settlement system (SSS) to agree on different applicable laws with different participants in the system might increase systemic risk.[25] This assertion must be rejected as totally unrealistic. First, it is highly improbable that a SSS would agree to have the accounts that it maintains for its participants be governed by different laws, given the operational complexities that might result, in particular with respect to settlement finality. Second, there seems little likelihood that a participant could offer sufficient incentive to induce, or have such bargaining power to force, a SSS to make such an agreement. Third, it is highly likely that a SSS within the European Community would be deterred from agreeing to different governing laws with different participants by the fear that it might thereby jeopardise its designation by a Member State as a "system" within the meaning of the Settlement Finality Directive.[26] Fourth, it is also quite possible that a SSS currently eligible for the

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25 This assertion was made in a letter, dated 18 November 2004, submitted to Mr A. Schaub (Director General, European Commission, Directorate General Internal Market) by the European Banking Federation (a copy of this letter was sent to the author by the EBF); see also a subsequent letter, dated 13 December 2004, sent by the EBF to the Civil Law Committee of the Council (this letter is available on the website of the EBF (www.fbe.be), under the headings "Documents & Publications" -> "Legal Affairs" -> "Other Issues: The Hague ...". Similar assertions were made by the European Central Bank (see *e.g.*, letter dated 16 January 2004 to the Committee on Civil Law Matters (General Questions), and letter dated 7 September 2004 to Mr Paul Meijknecht, Chairman of the Committee on Civil Law Matters, Council of the European Union; both letters on file with the author). The joint response of the Secretary General of the HCCH, Mr Hans van Loon, and Mr Bernasconi, to the EBF letter dated 18 November 2004 (referred to at the beginning of this footnote) can be found on www.hcch.net, under the headings "Welcome" -> "Conventions" -> "36" -> "Miscellaneous" (http://hcch.e-vision.nl/upload/schaub.pdf); also see on the same webpage an article published by Mr Bernasconi in L'AGEFI of 9 December 2004 entitled: *"La Convention de La Haye, une chance pour l'Europe !"*. See also the unsubstantiated comment number 6 from the EP in its resolution (see *supra* note 10).

26 See Art. 2(a) of the Settlement Finality Directive (mentioned in footnote 17 above).

settlement of collateral for Eurosystem credit operations would be deterred from agreeing to different governing laws with different participants by the concern that doing so might jeopardize its continued eligibility.[27] Accordingly, a settlement system (and particularly a European SSS) is, in practice, overwhelmingly likely to agree on the same governing law for all its accounts.[28]

It has also been asserted that the Convention's primary rule would lead to an increased impact of non-EU law (usually referring particularly to the law of New York), and that this would create a competitive advantage for United States institutions.[29] Again, both legs of this assertion must be firmly rejected. If there is any such risk, it is unrelated to the Convention and exists already in the absence of the Convention. Nothing currently prevents an investor based in Europe from opening an account with the New York office of a European intermediary, having European securities credited to that account, asking the intermediary to agree that New York law govern issues such as the legal nature of the rights resulting from the credit of securities to the securities account, and producing the result that some or all third party rights be governed by New York law (as can likewise currently be done with respect to directly held certificated securities simply by the investor getting on an airplane, taking the certificates to New York and pledging the securities (by delivery of the certificates to a lender there). In any event, opposing the Convention would not seem to be the appropriate response to an investor-held view (if such is the case) that non-EU law might be more advantageous to investors and their financiers. Furthermore, coping with New York or other law in the United States would hardly seem to be an unmanageable problem in these times of the ready availability of global legal advice and the extensive presence of affiliates and branches of many European institutions in the United States.[30]

It has also been argued that the Convention would lead to reduced investor protection.[31] This assertion, too, is without foundation. The Convention has no effect, and was not designed to have any effect, on how much protection a particular State's commercial or bankruptcy laws provide to investors as a result of their status as account holders, in particular in the event of an intermediary's bankruptcy. That is a

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27 The Governing Council of the European Central Bank periodically updates its assessment of SSS eligibility for such settlement activity. See the website of the ECB (http://www.ecb.int/press/pr/date/2004/html/pr040426_1.en.html).

28 See also the very persuasive comments by Deguée / Devos, *supra* note 6, para. 38.

29 See the references in footnote 25 above.

30 The December 10, 2004 issue of the American Banker noted: "The French banking giant BNP Paribas has emerged as a significant player in U.S. retail banking through two decades of acquisitions,… [describing the recently completed acquisition, through its Honolulu-based subsidiary, of a North Dakota entity] with more than 150 branches in 12 western and Midwestern states,… its executive vice president for international retail banking and financial services, said in a telephone interview Tuesday that BNP will continue to seek acquisitions on this side of the Atlantic. Its goal is to have the U.S. market generate 20% of earnings. … 'We consider [the U.S. market] as our second home market now.'" More broadly, an American Banker chart of "Foreign Holding Companies That Majority-Own U.S. Banks", published Dec. 14, 2004, ranked by assets of the U.S. banks as of June 30, 2004, indicates that HSBC Holding PLC (London) and ABN Amro (Amsterdam) each held over $100 billion in such assets, and that four of the top five holding companies are European-based (BNP Paribas being the fifth largest). UBS AG (Zurich) was the ninth largest. Moreover, UBS's wealth management operations in the United States, which have increased considerably in recent years, include the acquisition of PaineWebber, a leading stockbroker. See also Sigman / Bernasconi, *supra* note 6, pp. 33 and 34 [Myth five: The Convention is an attempt by US intermediaries to gain advantages over European intermediaries].

31 See the references in footnote 25 above.

matter for each State to decide. The Convention has no impact on where an intermediary's insolvency proceeding is likely to occur or the content of that State's insolvency law and its impact on the position of an investor. Investor protection rests on the prudent selection by investors of the intermediaries with whom they choose to do business and the effective supervision of intermediaries by those charged with regulation, not on the provisions of a private international law convention.

Finally, the following – one would think rather obvious – point cannot be overemphasised: the Convention has no impact on existing or future regulatory regimes controlling private conduct, whether toward the goal of preventing money laundering or preventing tax evasion, or assuring safe and sound business practices or minimising systemic risk. These questions are simply not within the scope of the Convention and therefore remain unaffected by it.[32] Thus, supervisory authorities are, in the exercise of their authority, free to prohibit intermediaries from choosing any governing law ('no choice at all'), or choosing a particular governing law ('applicable law cannot be the law X, Y or Z'), or choosing a governing law other than the law specified by the authority ('the applicable law must be the law of X'). Regulators and securities system operators are free to impose any of such actions as a condition to participation in a securities settlement system or to classification of obligations as acceptable for meeting credit standards (*e.g.* "eligible bank loans" in the Single List of Collateral in the Eurosystem Collateral Framework), or as a qualification for "designation" or in any other context (*e.g.* supervisory authorities may require that the Member State's law chosen to govern a system (under Art. 9(2) of the Settlement Finality Directive) must also be chosen as the relevant law for purposes of the Hague Securities Convention.

B. The fall-back rules (Art. 5)

If the primary conflict of laws rule does not apply, whether because the parties have expressly selected a governing law but the Qualifying Office requirement is not satisfied, or they have failed to make any express selection in their agreement or they have never concluded an account agreement at all, the Convention provides three fall-back rules which operate as a cascade (Art. 5).[33] The determinative elements used in the fall-back rules are (in sequence): the law of the place of the office that a written account agreement expressly and unambiguously identifies as the office through which the relevant intermediary entered into the account agreement (Art. 5(1)); the law of the place of incorporation or organisation of the relevant intermediary (Art. 5(2)); and the law of the (principal) place of business of the relevant intermediary (Art. 5(3)).

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32 See Explanatory Report, *supra* note 1, para. Int-59 and 2-35; see also the detailed analysis in Sigman / Bernasconi, *supra* note 6, pp. 31 and 32 [Myth one: The Convention would interfere with enforcement of anti-money laundering laws, tax laws or other similar regulatory measures; Myth two: The Convention would disempower supervisory authorities], and p. 35 [Myth eight: The Convention would override public policy]; Rogers, *supra* note 18, p. 42 *et seq*. Again, the fact that the Convention has no impact on regulatory and supervisory regimes is overlooked by the EP's resolution (see *supra* note 10; point 9 of the resolution).

33 The question whether an agreement on the governing law does not exist due to the absence of consent (*e.g.*, by reason of a generally applicable contract law doctrine such as lack of capacity) is governed by the conflict of laws rules of the forum other than those contained in the Convention. If, under the applicable substantive rule, consent is absent, there is in fact no agreement for the purpose of Art. 4(1) and the relevant fall-back rule of Art. 5 applies. If there is a consented-to agreement, a material rule depriving that agreement of legal effectiveness may be applied only in accordance with Art. 11 (see further comments below).

Articles 4 and 5 are complemented by Article 6, which provides that in determining the applicable law under the Convention no account is to be taken of the place where the issuer of the securities is incorporated or organised or has its statutory seat or registered office or place or principal place of business, or of the place where certificates representing or evidencing securities are located, or of the place where a register of holders is maintained by or on behalf of the issuer. Strictly speaking, Article 6 could have been dispensed with, but the provision was added to avoid any misunderstanding as to the Convention's firm rejection of any approach that would involve looking through an account holder's intermediary to determine the applicable law.

C. Transfers from one securities account to another, including through a chain of intermediaries

Articles 4 and 5 must be applied independently with respect to each securities account (*i.e.*, to each relationship between an account holder and its relevant intermediary). Thus, when a chain of intermediaries stands between an account holder and the issuer, there is no single law that would necessarily govern all the issues falling within the Convention's scope with respect to all securities accounts maintained by intermediaries standing between the account holder and the issuer. Similarly, when securities are transferred from one securities account to another, including transfers through a chain of intermediaries, the independent application of Articles 4 and 5 with respect to each securities account may and often will result in a different law governing the Article 2(1) issues with respect to each account. The Convention rejects the idea of a "Super-PRIMA" which would apply the same law governing the Article 2(1) issues with respect to every securities account maintained by each intermediary standing between an account holder and the issuer or with respect to every securities account involved when a transfer of securities is made from one account to another through a chain of intermediaries (assuming such a linkage could be in fact established in current trading and settlement systems).[34]

IV. Other important provisions of the Convention

A. The scope of the Convention and of the applicable law (Art. 2)

The Convention is a *pure conflict of laws convention*. Therefore, it does not impose any changes on existing (or limits on future) substantive law, in particular regarding the nature of an investor's interest in securities held with an intermediary or the requirements concerning how such an interest may be provided as collateral or otherwise transferred. Second, the Convention deals only with issues relating to securities[35] *held with an intermediary*. As a result, if the securities are held *directly*, that is, there is no intermediary involved and the investor's interest is recorded on the books of the issuer or is embodied in bearer certificates in the investor's possession, the Convention does not apply.[36]

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[34] For a comprehensive description of transfers through a chain of intermediaries, see the Explanatory Report, *supra* note 1, para. 4-43 *et seq*.

[35] The definition of the term "securities" is discussed in section B below.

[36] The provisions in Art. 1(3)–(5) are designed to clarify whether certain persons (including certain systems and their participants) should be regarded as intermediaries for the purposes of the

In the context of these important parameters, Article 2 defines the scope of the Convention and of the applicable law. Article 2 is best understood when read with the following guidelines in mind: (i) the key provision is Article 2(1); (ii) Article 2(2) is merely a clarification of Article 2(1); (iii) Articles 2(3)(a) and (b) are subject to Article 2(2) and are merely illustrative; and (iv) Article 2(3)(c) states an absolute exclusion.

The Convention law (*i.e.*, the law determined by the Convention's conflict of laws regime in Arts. 4, 5 and 6) is the applicable law that determines all the issues enumerated in the exhaustive but very broad and intentionally very generally worded list in Article 2(1) (the "Article 2(1) issues"). The list in Article 2(1) is intended to be comprehensive and to include all issues that might have practical significance. An issue not specified in Article 2(1) does not fall within the Convention's scope and, therefore, is not governed by the applicable substantive law determined by the Convention. It is not possible, in respect of a particular securities account, for some Article 2(1) issues to be governed by one law and others by a different law.

Most significant among the issues listed in Article 2(1) are the *legal nature and effects against the intermediary and third parties of rights resulting from a credit of securities* to a securities account (Art. 2(1)(a)), and the *legal nature and effects against the intermediary and third parties of a disposition*[37] of securities held with an intermediary (Art. 2(1)(b)). As discussed above, the approaches to securities held with an intermediary vary among legal systems. In some systems, the account holder's rights resulting from a credit of securities to a securities account are characterised as a form of property right. In other systems, the account holder's rights are characterised as a form of purely personal (contractual) right against the intermediary to the delivery or transfer of a given type and number of securities. In still other systems, the account holder's rights are characterised or denominated as the interest of a beneficiary under a trust, a fiduciary interest, a *Gutschrift in Wertpapierrechnung*, co-property rights in a fungible, notional or book-entry pool of securities, security entitlements or some other bundle of property, contractual or other rights.[38] These differences, however, do not matter under the Convention, which caters to the needs of all these approaches and applies to securities held with an intermediary regardless of how the relevant substantive law classifies the nature of the right resulting from the credit of the securities to the securities account, and independently of whether this right is against the investor's intermediary, any other intermediary or the issuer. For the sake of clarity and to avoid any doubt, Article 2(2) explicitly confirms the Convention's applicability even in situations where, under the Convention law, the rights resulting from the credit of securities to a securities account are determined to be contractual in nature.[39]

Convention. For a full description of these provisions, see the Explanatory Report, *supra* note 1, paras. 1-32 to 1-40.

37 As defined in Art. 1(1)(h), the term "disposition" covers any transfer of title, whether outright or by way of security, and any other form of security interest. "Disposition" includes sale and repurchase (repo), purchase and resale (reverse repo), transfers under sell/buy-back or buy/sell-back arrangements and stock loans.

38 For a more complete discussion of the various substantive law models, see the Explanatory Report, *supra* note 1, paras. Int-22 and Int-23, 2-11 *et seq.* (with further references).

39 Unfortunately, the English and French texts of Art. 2(2) do not match. While the English text correctly refers to both a "disposition of" and "an interest in" securities (and thus covers both dynamic and static situations), the French text only refers to a disposition (of either securities or an

As indicated, the Convention does not determine the law which governs issues *not* falling within Article 2(1). This category includes, for example, issues relating to such purely contractual or other purely personal rights and duties between an account holder and its intermediary *inter se* as the content and frequency of account statements, the intermediary's standard of care in maintaining securities accounts, risk of loss, deadlines in giving instructions, and the like (Art. 2(3)(a)). Similarly, this category includes such contractual or other personal rights and duties between the parties to a disposition *inter se* as the number and type of securities agreed to be sold or their purchase price (Art. 2(3)(b)). These sets of issues are outside the domain of the Convention law because they are not within the issues listed in Article 2(1), not because they are excluded by Articles 2(3)(a) and (b). These latter two provisions, which are both subordinated to Article 2(2), are not intended, and should not be read, as limitations or qualifications of the reach of Article 2(1) but merely as illustrative of those contractual or other personal rights that do not fall within Article 2(1) altogether. The law applicable to those contractual rights between an account holder and its intermediary (or between the parties to a disposition) *inter se* which do not fall within Article 2(1) is determined not by the Convention but by other conflict of laws rules of the forum.

While the issues embraced in Articles 2(1)(a) and (b) are extremely broad, the list of issues within the domain of the Convention law does not stop there. The Convention also determines the law applicable to the *perfection*[40] requirements of a disposition (Art. 2(1)(c)) and whether an interest extinguishes or has *priority* over another person's interest (Art. 2(1)(d)). Thus, the law determined by the Convention will govern, *inter alia*, the priority between a person who acquired an interest in securities in good faith, for value and without notice of an adverse claim (a so-called "bona fide purchaser" or "protected purchaser") and an adverse claimant. Article 2(1)(d) includes not only the simple issue of priority, but also the effects of a priority decision – that is, whether the competing interests co-exist, with one being preferred over the other, or one takes free of the other altogether. The Convention does not resolve these priority and effects issues; it simply provides the conflict of laws rule to determine which substantive law will govern these matters.

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interest in securities). The history and purpose of Art. 2(2) clearly reveal that the English version is correct and that the French text must be read accordingly. This result is expressly confirmed by the Explanatory Report, *supra* note 1, para. 2-31.

[40] In many legal systems, a security interest or other disposition, though effective as between the parties by virtue of their agreement, is not effective against a third party acquiring an interest in the subject-matter unless some further step has been taken. Art. 1(1)(i) defines "perfection" as the completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition, including an insolvency administrator and general creditors in the debtor's insolvency proceedings. For example, for a security interest to have any effects beyond the secured party and the debtor, the applicable law may require, in addition to the secured party and the debtor entering into a collateral agreement, that the secured party take control over the securities account, have the encumbered securities credited to an account in the secured party's name, make a public filing, or take some other step. For certain dispositions, the applicable law may not require the parties to take any particular steps beyond their agreement in order to make the dispositions effective against third parties. For example, the applicable law may deem an intermediary to have "control" over a securities account that is encumbered in its favour (and, thus, over all securities credited to that securities account), if the intermediary is the person who maintains the securities account for the debtor/account holder, with no further step beyond the agreement being required for effectiveness of the security interest against third parties.

Further, the Convention law also governs *whether an intermediary has any duties to a person other than the account holder who asserts, in competition with the account holder or another person, an interest in securities held with that intermediary* (Art. 2(1)(e)). This includes, for example, whether the intermediary is protected if it honours an instruction from one claimant even if it is later found that another claimant has priority. It also includes the important question of whether so-called upper-tier attachments are permissible (*i.e.*, an effort to reach an account holder's interest in securities by levying an attachment against an intermediary at a level above that of the account holder's intermediary).

The Convention law also governs the requirements for the *realisation* of an interest in securities held with an intermediary (Art. 2(1)(f)). Finally, the Convention law also governs whether a disposition of securities held with an intermediary extends to entitlements to dividends, income, or other distributions, or to redemption, sale or other proceeds (Art. 2(1)(g); see the comments below at the end of section IV, B)).

It is readily apparent that more than one sub-paragraph of Article 2(1) may embrace a particular issue. There is nothing to be gained from determining which particular sub-paragraph applies; it suffices that the issue falls within the list. For example, the granting of a security interest in securities held with an intermediary is a disposition; accordingly, under Article 2(1)(b), the Convention determines the law applicable to the "effects against the intermediary and third parties" of the security interest. A dispute requiring determinations concerning the perfection and priority of the security interest would fall within Article 2(1)(b); yet it also would likely fall within the more specific Articles 2(1)(c) and (d).

The Convention does *not* under any circumstances determine the law applicable to the rights and duties of an issuer of securities or of an issuer's registrar or transfer agent (Art. 2(3)(c)). This exclusion encompasses the duties of an issuer with respect to all corporate actions, including voting rights, dividend rights and registration rights, and the rights of an issuer to define the steps for achieving good discharge of a note, bond or other debt security.

Finally, the Convention has no impact on regulatory schemes relating to the issue or trading of securities, regulatory requirements placed on intermediaries, or enforcement actions taken by regulators. While there is no explicit language spelling out this exclusion, the result is clear from the fact that these issues are not specified in the list of Article 2(1) issues.[41]

B. The definition of "securities" (Art. 1(1)(a))

The definition of the term "securities" set forth in Article 1(1)(a) is intentionally both very broad and very general. The term extends to all assets that are financial in nature, whether they are in bearer or registered form and whether they are represented by a certificate or dematerialised. The term encompasses all types of debt and equity securities. The term includes financial instruments and financial assets that are standardised, negotiable, dealt in on an organised market, or capable

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[41] See the comments above, under heading III.A.4. *in fine*.

of being traded (none of these characteristics, however, is required).[42] The only personal (movable) property excluded from the term is (i) cash and (ii) assets that are not financial in nature (such as land or machinery). The breadth of inclusiveness reflects the policy decision that the Convention's coverage would accommodate both the existing range of practice in diverse financial markets and future developments in market practice.

"Securities" is in no way limited to (or otherwise related to) definitions of that term found in the regulatory regime of any State. Those definitions were developed for other purposes and they would be too narrow for purposes of the Convention; moreover, it is highly unlikely that consensus could have been achieved on the choice of a particular regulatory definition in light of the diversity of those definitions in national regulatory activity around the world. Thus, precedents determining that an asset is not a security in a particular State, or in a different context, should not result in exclusion from the Convention's coverage. Of course, States remain free to limit the types of financial assets that may be credited to a securities account by intermediaries that are subject to their regulation.

Despite the Convention's extremely broad definition of "securities", there is no risk of undesirable over-inclusion. This is because of the existence of two substantial limitations on the scope of the Convention: first, the requirement that the securities be "held with an intermediary" (see Art. 1(1)(f)), excluding direct holdings and, more importantly, encompassing only assets susceptible of being credited to a securities account; and second, the limitation of the domain of the Convention law only to matters falling within the Article 2(1) list. Thus, there was no need to rely on the definition of "securities" to limit the scope of the Convention. Therefore, no court or legal adviser need be long delayed by the effort to determine whether an asset is a security: if an asset is credited to a securities account and is financial in nature, it is a security within the meaning of the Convention.

The definition of securities expressly excludes "cash". The term "cash" is not confined to physical money but also encompasses ordinary deposit accounts, even if maintained by the intermediary who also maintains a securities account for the same account holder. "Securities" does not extend to cash paid to the intermediary toward the cost of acquiring securities on behalf of the account holder or providing margin cover. Issues relating to rights in that cash are governed not by the Convention law, but by the applicable law determined by other conflicts rules of the forum, and this is so whether the cash is credited to the securities account or to a separate cash account maintained by the intermediary. The Convention law *does*, however, govern whether a disposition of securities held with an intermediary extends to entitlements to dividends, income or other distributions, or to redemption, sale or other proceeds, in the form of cash or credits to a cash account – issues which are expressly mentioned in Article 2(1)(g).

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[42] Clearly falling within the Convention's definition of securities are shares of stock, bonds, units in collective investment schemes, exchange-traded financial futures and options, credit derivatives, short-term promissory notes (commercial paper) issued on a money market, warrants and American Depositary Receipts. The definition also includes financial instruments that are structured to have no element of usury, high degree of uncertainty or gambling as a matter of Islamic law.

C. Article 3 ("Internationality")

The purpose of Article 3 is to ensure the applicability of the Convention whenever a situation involving securities held with an intermediary relates in any way to more than one State. Only by providing for maximum applicability can the Convention achieve its goal of providing certainty and predictability. Thus, the function of Article 3 is to include, rather than to exclude; and, for this reason, all doubts about coverage should be resolved in favour of inclusion.

Article 3 does not define the applicability of the Convention by reference to specific, pre-established and precisely delineated factors or by means of a definition of "internationality" which would have to be satisfied at a particular point in time and against which parties and courts would have to assess facts to determine whether or not the Convention applies. Rather, the provision takes a broad descriptive approach by stating that the Convention applies in all cases involving "a choice between the laws of different States", that is, it applies unless there is absolutely no aspect of a situation (*e.g.*, 'location' of a person involved in or affected by a transaction or of an activity of such a person, 'location' of a security or its issuer, presence of a governing law clause or any other 'governing law' factor or element) which might give rise to a claim for the applicability of the law of more than one State. Only a formulation that does not depend on the development of a coherent interpretation of Article 3 by courts, but instead declares a broad scope of application which cannot be avoided by (mis)interpretation of the verbiage used, enables parties to a disposition, as well as affected third persons, to enjoy the legal certainty and predictability that the Convention seeks to provide.

It is important to stress that the principle of *fraus legis* (or similar principles such as the *bona fide* principle under English law) cannot displace the applicability of the Convention where the latter is triggered by the parties' choice in favour of the law of one State even if all the factors relevant to the situation are connected with another State.[43]

D. Impact of opening of an insolvency proceeding (Art. 8)

Article 8 fixes the boundary between the Convention law (*lex causae*) and the applicable insolvency law (*lex concursus*) in the context of an insolvency proceeding. It provides that pre-insolvency rights, which are effective and perfected under the Convention law, are to be respected as such in an insolvency proceeding (Art. 8(1)), but that these rights are not thereby exempted from general insolvency rules relating, for example, to the ranking of claims, enforcement of rights, and the avoidance of unfair preferences and transactions in fraud of creditors (Art. 8(2)). Accordingly, despite the opening of an insolvency proceeding, the Convention law will continue to apply to all Article 2(1) issues as regards pre-insolvency events (such as an outright sale or the grant of a security interest), and an insolvency court or administrator may not refuse to recognise the right or its perfected status merely because this right had not (also) been created or perfected in accordance with the *lex concursus*. The *lex concursus*, however, determines the effects of those rights, that is, the extent to which these rights can be used in the insolvency proceeding. For example, a security interest perfected in accordance with the Convention law

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43 See Explanatory Report, *supra* note 1, Example 3-3 and para. 3-10.

during a 'suspect period' may be avoided as a 'preference' or 'fraudulent conveyance' and its pre-insolvency priority under the Convention law may be displaced by the rule of the insolvency forum governing the ranking of claims, to the same extent as a security interest perfected in accordance with the *lex concursus* under the same circumstances.

E. Public policy and internationally mandatory rules (Art. 11)

Article 11 carefully restricts the grounds for judicial refusal to apply the Convention law. Article 11(1) sets forth a public policy (*ordre public*) exception under which the application of the Convention law may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum State, that is, depart so radically from the forum's concepts of fundamental justice that its application would be intolerably offensive to the forum's basic values. Article 11(2) provides for the exclusive application of the forum's internationally mandatory rules, that is, those *substantive* rules (*i.e.,* not private international law rules) of the forum (not those of other States), often referred to as laws of immediate application, which must be applied despite the fact that the Convention determines another law to be applicable and irrespective of the effects application of the Convention law would have. The threshold for the application of the internationally mandatory forum rule exception, like that for the public policy exception, is very high (safeguard of fundamental moral, social, economic or political principles). Thus, it is to be expected that both exceptions will be applied extremely rarely. Moreover, and most importantly, both these exceptions are subject to Article 11(3), which precludes them from being used to impose any perfection requirements of the forum on any consensual security interest or other disposition (including a statutory lien falling within Art. 1(2)(c)) in lieu of or in addition to the perfection requirements of the Convention law,[44] or to apply any rule of the forum relating to priorities between competing interests (unless, of course, the law of the forum is the Convention law). Article 11(3) is a crucial provision. Without the strict limitation of both the public policy and the internationally mandatory forum rule exceptions, the legal certainty and predictability provided by the Convention would be undermined and the achievement of the Convention's benefits, sought by the forum along with all other Contracting States, would be thwarted.[45] As the Explanatory Report rightly emphasises, "Article 11(3) is not at all a derogation from the Contracting State's public policy; rather, it is a clear announcement of what that policy is."[46] Like all other provisions of the Convention, Article 11(3) leaves unaffected the ability to apply the forum's regulatory laws such as anti-money laundering or anti-tax evasion laws.[47]

F. Transition provisions (Arts. 15 and 16)

The chapter entitled "transition provisions" (Chapter IV of the Convention) contains two articles which, although each reflects the fact of possible change in

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44 See Explanatory Report, *supra* note 1, para. 11-12.

45 Again, this is not recognised by the EP's resolution (see *supra* note 10), when in point 8 it refers to the "highly inadequate nature" of the "exemptions with regard to the public policy rules [of the Convention]."

46 *Ibid.*

47 For a more complete analysis of Art. 11 and particularly of Art. 11(3), see Explanatory Report, *supra* note 1, especially para. 11-12.

practice or legal outcome brought about by the advent of the Convention, deal with completely separate issues.

Article 15 addresses the situation of a priority dispute between an interest acquired after the Convention's entry into force for a State and an interest acquired before the Convention's entry into force for that State. For example, such a priority contest might arise where, before the Convention's entry into force for the forum, an account holder grants a security interest in securities held with an intermediary to Lender A and, subsequent to the Convention's entry into force for the forum, the same account holder grants a security interest in the same securities to Lender B.[48] Article 15 provides that the Convention's conflict of laws rule (either Art. 4 or 5) applies to determine which State's law will govern this priority dispute. As a result, application of the Convention law may have an effect on "pre-Convention" interests (for example, the Convention law may determine that Lender A's pre-Convention interest is subordinate to or extinguished by Lender B's post-Convention interest). The rule should cause no difficulty in practice as parties to existing (pre-Convention) account agreements have ample opportunity to adjust their arrangements to take into account the possible application of the Convention to determine the applicable law. In any event, in most situations, potential application of the Convention law to govern that priority contest will have been anticipated.[49]

Because the Convention's references to account agreements and securities accounts include agreements entered into, and accounts opened, before the entry into force of the Convention on the international plane[50] (see Art. 16(1)), it was deemed advisable to provide rules for the interpretation of such account agreements. Article 16 provides guidance for parties who have entered or are now entering into such pre-Convention account agreements, and enables currently existing and still-to-be-entered-into pre-Convention account agreements to enjoy the benefits of the Convention without the parties having to engage in the costly exercise of amending these agreements or opening new accounts. Articles 16(3) and (4) provide interpretive rules that treat certain provisions of pre-Convention account agreements as having the effect of determining, for the purposes of Article 4(1) of the Convention, the law applicable to all the Article 2(1) issues. Thus, if express words in a pre-Convention account agreement would, under the rules of the State whose law governs the contract, have the effect of determining the law governing any of the Article 2(1) issues, that law will govern all those issues, but only if the Qualifying Office test was met at the time of the agreement on governing law.[51] Similarly, if the

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48 The interests referred to in Art. 15 need not be of the same type. Thus, the priority contest might be between two persons that have security interests, between two account holders, between an account holder and a person having a security interest or between a person having a security interest and an attaching creditor. See Explanatory Report, *supra* note 1, para. 15-3.

49 The Explanatory Report, *supra* note 1, paras. 15-1 and 15-4, makes clear that other than in the context discussed above, the Convention is silent as to whether the Convention law may or must be applied to govern any other issue or be given any other effect with respect to pre-Convention interests or dispositions (except to the extent otherwise provided in Art. 16, discussed below).

50 Under Art. 19(1), the Convention enters into force on the international plane on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession by a State.

51 For example, existing account agreements governed by state law or federal law in the United States frequently contain provisions either specifying the relevant intermediary's "jurisdiction" or selecting a governing law. These provisions have the effect, under that state or federal law, of determining the law governing at least some of the issues specified in Article 2(1). Parties who include such provisions in such account agreements can be presumed to have expected the

parties to an account agreement (other than one to which Art. 16(3) applies) have agreed, pre-Convention, that the securities account is maintained in a particular State, the law of that State will be the applicable law under the Convention, but only if the Qualifying Office test was met at the time of the agreement on governing law;[52] in this particular situation, the agreement as to where the securities account is maintained may be express or implied from the terms of the contract considered as a whole or from the surrounding circumstances (subject to the prohibition in Art. 6).

The interpretive rules of Articles 16(3) and (4) apply only if the account agreement does not contain an express reference to the Convention. If an account agreement contains an express reference to the Convention, Articles 4, 5 and 6 are to be applied directly, without any interpretive assistance from Articles 16(3) and (4). Thus, a simple way to ensure that the benefit of legal certainty and predictability provided by the Convention extends to an account agreement concluded prior to the entry into force of the Convention is to expressly refer to the Convention in the agreement. The authors have been informed that this practice is already being followed.

Article 16 also allows for some declarations by Contracting States. Under Article 16(2), a State may declare that its courts will not rely on the interpretive rules of Articles 16(3) and (4) in applying Article 4(1) to account agreements entered into during the period between the date the Convention enters into force on the international plane (Art. 19(1)) and the date the Convention enters into force for that State ("Gap Period"). If a Contracting State makes such a declaration, the courts of that State will apply Articles 4, 5 and 6 to Gap Period account agreements without any interpretive assistance from paragraphs 3 or 4. In addition, under Article 16(3), a State may make a declaration that the courts of that State will not apply the interpretive rule of Article 16(3) if the parties to the account agreement have expressly agreed that the securities account is maintained in a different State than the State whose law would otherwise be applicable by reason of the interpretive rule of Article 16(3).[53]

V. A brief overview of the remaining provisions

Article 12 sets forth several important interpretive and substantive provisions relating to the application of the Convention with regard to Multi-unit States (*i.e.*, States within which two or more territorial units of that State, or both the State and

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consequences provided by that governing law and, under Art. 16(3), those expectations will be fulfilled as that law will govern all the Article 2(1) issues

[52] For example, existing account agreements governed by the law of a Member State of the European Community frequently indicate agreement, either expressly or implicitly, on where the relevant securities account is maintained. Parties to such agreements can be presumed to have intended that the law of that place would govern all the Article 2(1) issues. Under Art. 16(4), that expectation will be fulfilled (see the further comments in the main text and the following footnote regarding the possibility of a declaration under Art. 16(3)).

[53] Such a declaration addresses the situation when the parties to the account agreement have expressly agreed that the securities account is maintained in a particular State but the operation of Art. 16(3) would designate the law of a different State as the governing law. An Art. 16(3) declaration precludes Art. 16(3) from having that effect. Thus, a State which considers that parties who make such an express agreement would have expected the Art. 2(1) issues to be governed by the law of the location specified as the place of the maintenance of the securities account, and wishes to protect that expectation, may want to make an Art. 16(3) declaration.

one or more of its territorial units, have their own rules of law in respect of any of the Article 2(1) issues; see the definition in Art. 1(1)(m)). In particular, Article 12(1) sets out how the Convention's primary conflicts rule operates when the parties have designated the law of a particular territorial unit of a Multi-unit State. When the parties have expressly agreed on the law of a particular territorial unit of a Multi-unit State (either as the law governing the account agreement or as another law governing all the Art. 2(1) issues), the applicable law is the law of that specified territorial unit, if the relevant intermediary has a Qualifying Office anywhere in the Multi-unit State. A Multi-unit State may, however, by declaration, impose a geographically more stringent condition by requiring that the applicable law will, under Article 4, be that of the one of its territorial units agreed by the parties only if the relevant intermediary has a Qualifying Office within that territorial unit.[54]

The law determined by the Convention is the applicable law whether or not it is the law of a Contracting State (Art. 9). Furthermore, the Convention does not leave any room for *renvoi* in the traditional private international law sense: the applicable law determined by the Convention refers to substantive rules only, not to conflict of laws rules (Art. 10).[55]

Article 13 calls for uniform interpretation of the Convention. The importance of this principle is reinforced by the provision in Article 14 for Special Commission meetings to review the practical operation of the Convention. The legal certainty and predictability that the Convention is designed to provide would not be achieved, however, if judges or practitioners were to reach differing views as to the interpretation or practical implementation of the Convention.

Article 7 determines the impact, if any, under the Convention of an amendment to an account agreement if the consequence of the amendment is that the Convention law changes from the law of one State as determined under either Article 4(1) or Article 5, to the law of a different State as determined under Article 4(1). The principle embodied in Article 7 is that the "new law" governs all the Article 2(1) issues in respect of any interest in securities previously or subsequently credited to the securities account governed by the amended account agreement (Art. 7(3)), subject to exceptions with respect to specified issues which are designed to protect certain interests in securities that were acquired before the amendment by a person who did not consent to the amendment (see Arts. 7(4) and (5)). It is expected that Article 7 will come into play only rarely since the kinds of amendments to which it would apply are very likely to be infrequent. Article 7 does not come into play in the situation when the parties fail to select a new applicable law under the Convention which satisfies the requirements of Article 4(1) (including the Qualifying Office requirement of the second sentence of Art. 4(1), which must be met at the

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[54] For a more detailed presentation of Art. 12, see the commentaries in the Explanatory Report; also see the following footnote.

[55] Art. 12(2)(b) and Art. 12(3) both provide for an internal *renvoi* in the context of Multi-unit States. Art. 12(2)(b) provides that if the conflict of laws rules in force in a territorial unit of a Multi-unit State designate the law of another territorial unit of that State to govern perfection by public filing, recording or registration, the law of that other territorial unit governs that issue. Under Art. 12(3), a Multi-unit State may file a declaration to the effect that if the applicable law, determined under Article 5, is that of the Multi-unit State or one of its territorial units, the internal conflict of laws rules in force in that Multi-unit State must be applied and it is those rules which will determine whether the substantive law of that Multi-unit State or of a particular territorial unit of that Multi-unit State shall apply.

time of the amendment). When the requirements of Article 4(1) are not met, the amendment is ignored for Convention purposes and the *status quo ante* with respect to the determination of the applicable law is preserved.[56] Furthermore, Article 7 also does not come into play when a different law becomes the Convention law as a result of a transfer of securities to another securities account. Thus, Article 7 does not come into play in the case of an outright transfer of securities to a buyer or where a security interest is implemented by means of a transfer of the securities from a collateral provider's account to a collateral taker's account. In these instances the rights resulting from the credit of securities to the buyer's and collateral taker's account, as well as all the other Article 2(1) issues, are governed by the Convention law determined with respect to the buyer's and collateral taker's account, respectively.[57]

Articles 17 to 24 contain the final clauses, including a provision (Art. 18) that enables a Regional Economic Integration Organisation (REIO) constituted by sovereign States to sign, accept, approve or accede to the Convention, but only to the extent it has exclusive competence over matters covered by the Convention; it is the first time that such a provision has been included in a Convention adopted under the auspices of the Hague Conference.[58]

VI. Conclusion

The Hague Securities Convention is the result of a highly focused, inclusive and representative effort to provide legal certainty and predictability as to the law governing issues that are of great practical importance for the holding and transfer of securities held with an intermediary. The Convention provides a clear, straightforward, pragmatic and easily applicable solution to a technically complex issue. This *ex ante* legal certainty is essential for the effective and smooth operation of the financial markets, which are increasingly interconnected. The Convention, thus, brings very important benefits to market participants and the financial system as a whole. It is hoped that the example set by the United States of America and Switzerland – two of the most important and sophisticated financial markets – will soon be followed by other States and by the European Community and that this important instrument will enter into force as soon as possible.

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[56] Thus, such an amendment does not lead to the application of Art. 5(2) or (3); and no amendment can lead to the application of Art. 5(1) because Art. 5(1) is applicable only if the requisite condition existed at the time the account agreement was originally entered into. See Explanatory Report, *supra* note 1, para. 7-1.

[57] For a more detailed presentation of Art. 7, see the commentaries in the Explanatory Report.

[58] Art. 18 of the Hague Securities Convention closely follows Art. 48 of the *Cape Town Convention of 2001 on International Interests in Mobile Equipment*.