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POSITION ON CONFLICT OF LAW APPLICABLE TO SECURITIES & CLAIMS

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SUMMARY

On 12 March 2018, the Commission's published a proposal for a **Regulation on the law applicable to the third-party effects of assignments of claims**, accompanied by a **Communication clarifying the applicable law to the proprietary effects of transactions in securities**.

As regards the **Communication**, while not proposing any formal change to existing conflicts of laws rules relating to the proprietary effects of securities transactions, the Commission suggests an interpretation of those rules which amounts to introducing the Hague Convention on intermediated securities. It may result in enabling intermediaries to choose the law applicable to proprietary rights on the basis of a law from outside the EU jurisdiction where the securities settlement system is located, thus reintroducing systemic risk. Furthermore, through such a choice, intermediaries could interfere with the law of creation of the securities in some instances depriving the end-investors of its ownership in securities. We therefore urge the Commission to **clarify its Communication by removing any reference to the free choice of law principle**.

Concerning the Commission's proposal for a Regulation, it provides a new uniform conflict of laws rule whereby the law that governs the third-party effects of "assignment of claims" is the law of the country where the assignor has its habitual residence. This would ensure that the same law applies to resolve priority conflicts that may arise between the assignee and competing claimants. However, as the underlying securities are not explicitly excluded from the category of claims arising from derivatives contracts, the scope remains ambiguous. To ensure legal certainty**,** we believe it is necessary to **clarify that securities and claims arising from securities are outside the scope of this Regulation**.

CONTEXT

Legal certainty regarding the law applicable to certain issues relating to the ownership, holding, transfer and collateralisation of book-entry securities owned by end investors and held with intermediaries in an international context is of critical importance. The same goes for reducing systemic risks that might result from any legal uncertainties.

Conflicts of law rules laid down in the Financial Collateral Directive, in **the Settlement Finality Directive and the Winding Up Directive have increased legal certainty** and have **shown to function correctly, e.g.** including in the liquidation of Lehman Brothers collateralized positions at CCPs.

Nevertheless, the debate on the possible changes of the European legal framework continued. Some have been advocating that the EU Member States should become a party to the Hague Securities Convention or change the existing EU conflict of law rules to a Hague-like rule.

DETAILED COMMENTS ON THE COMMISSION'S COMMUNICATION

In the Commission's view, diverging interpretations concern:

- differences in wording (account "maintained or located") when referring to the place of the account or register; and
- different ways to determine where a securities account is 'located' or 'maintained'.

We support the Commission's assessment that the former does not imply any difference in substance ('located' means the same as 'maintained') if this is understood to always refer to the place where the end investor has set up the securities account with an intermediary, usually the domicile or residence of the end investor. Securities accounts can be provided by global custodians with a presence in the European Union offering services to European investors, but at the same time running their IT systems in a country outside the EU. There are legal concepts (mainly outside the EU) which disenfranchise end investors of their securities handing over ownership in the securities to intermediaries leaving end investors only with a claim against the intermediary. If "maintained" is interpreted to refer to the place where the custodian has established its operations this opens the door to manoeuvres to the detriment of European investors and consumers. It is thus important not to give discretion to a custodian to move around the place where the securities account is "maintained" if one wants to protect end investors against loss of ownership in their securities.

The Commission expresses the view that interpretations given by Member States differ and may reintroduce uncertainty regarding the latter. It claims that:

a. Some MS interpret and apply the Financial Collateral Directive in such a way that the place of the relevant register or account is the place where the custody services are provided;

b. Others look at the provisions of the account agreement to determine the place where the account is maintained;

c. The third approach, according to the Commission, would be to choose the MS law that would be valid under the Hague Securities Convention (which reserves "party autonomy" to the parties of the "account agreement" and therefore allows the parties to choose the applicable law).

We agree with interpretations given under points a) and b) above, which comply with the relevant provisions of the three Directives (the Settlement Finality Directive, Financial Collateral Directive and Winding-up Directive), if this is interpreted to refer to the place where the investor has set up the account is operated from by the intermediary. However, recognising the interpretation under point c above would amount to introducing the Hague Convention on intermediated securities by the back door although the European co-legislators, the Parliament and the Council, have explicitly refused to sign it into the European law.

We believe that contrary to the intention of the Commission, legal uncertainties and even systemic risk may arise from the application of the free choice of laws principle recognised under the Hague Convention.

Situation from before EC Communication

The custody of and transactions in intermediated securities touch upon several bodies of law, the following of which are of particular importance (and to each of which corresponds a set of conflicts rules):

- The lex contractus governs the relationship between the parties to the securities custody agreement. Pursuant to the Rom 1 regulation the lex contractus is based on the free choice of law principle. In the absence of choice, the applicable law is determined on the basis of a scale of connecting factors defined in the regulation.
- The lex societatis regulates the relationship between issuers and their shareholders (bond holders and determines the rights and obligations enshrined in a "security".
- The lex rei sitae designates the law applicable (insofar as not in conflict with the creation law) to proprietary effects of securities transactions and is based on the place of the relevant register or account.

The legal regime introduced by the three aforementioned directives (the Settlement Finality Directive, Financial Collateral Directive and Winding-up Directive) can function effectively, only if the law governing the proprietary aspects of securities held in a securities account with the Securities Settlement System – SSS, is identical to the law under which the securities have been created and to the law governing the Securities Settlement System, in order to safeguard systemic finality, certainty and transparency.

Under the system from before the Commission Communication, application of lex rei sitae automatically flows from the choice of a Member State law as governing the securities custody agreement. By definition, the acquis communautaire applies in such circumstances. The choice of the law of a third country would call into question the application of EU mandatory rules, including lex rei sitae. The choice of the law of a third country would call into question the application of EU mandatory rules, including lex rei sitae.

Uncertainties created by reintroducing the free choice of law principle of the Hague Convention

Acknowledging this principle, may cause the parties to the custody agreement to consider choosing a third-country's law either through a general choice-of-law clause covering all aspects of their relationship, including proprietary aspects, or standard clause covering only their respective rights and duties. In both cases, the EU acquis, including lex rei sitae, would be disregarded.

Far from clarifying how the lex rei sitae principle should be implemented, the position expressed by the Commission causes serious legal risks and uncertainties. We therefore urge it to remove any ambiguity and make clear that the creation law has priority over other laws and the intentions of investors have priority over the interests of intermediaries and that intermediaries shall not have the freedom to choose the applicable law, as provided in the Hague draft Convention, against the creation law and the intentions of the investors.

PROPOSAL FOR A REGULATION ON THIRD PARTY EFFECTS OF ASSIGNMEENT OF CLAIMS

The Commission proposes a new uniform conflict of laws rule whereby the law that governs the third-party effects of "assignment of claims" is the law of the country where the assignor (i.e. the creditor that transfers his right to a claim against a debtor to a third party) has its habitual residence. This would ensure that the same law applies to resolve priority conflicts that may arise between the assignee and competing claimants. The Comission asserts that the scope of the conflict of laws rules in the draft regulation does not overlap with that of the conflict of laws rules in the three Directives as the former apply to claims and the latter to book-entry securities. However, the **exact scope remains ambiguous** as the Commission **does not explicitly exclude the underlying securities from the categorie of claims arising from derivatives contracts** (e.g. the amount due after the calculation of a close-out in such a contract). We therefore urge EU co-legislators to specifically **exclude securities from the scope of the proposed regulation.**

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