

P.R.I.M.E. Finance

Panel of Recognized International Market Experts in Finance

Conflict of Laws Rules for Book-Entry Securities



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Agenda

- **I. The Conflict of Laws in the Securities Intermediation Context**
- **II. Four Possible Solutions**
 - a) Lex rei sitae Rule
 - b) Look-through Approach
 - c) Place of the Relevant Intermediary Approach (PRIMA)
 - d) Choice of Law
- **III. The Hague Securities Convention (HSC)**
- **IV. Implementation of the HSC into National Law**
- **V. Outlook**

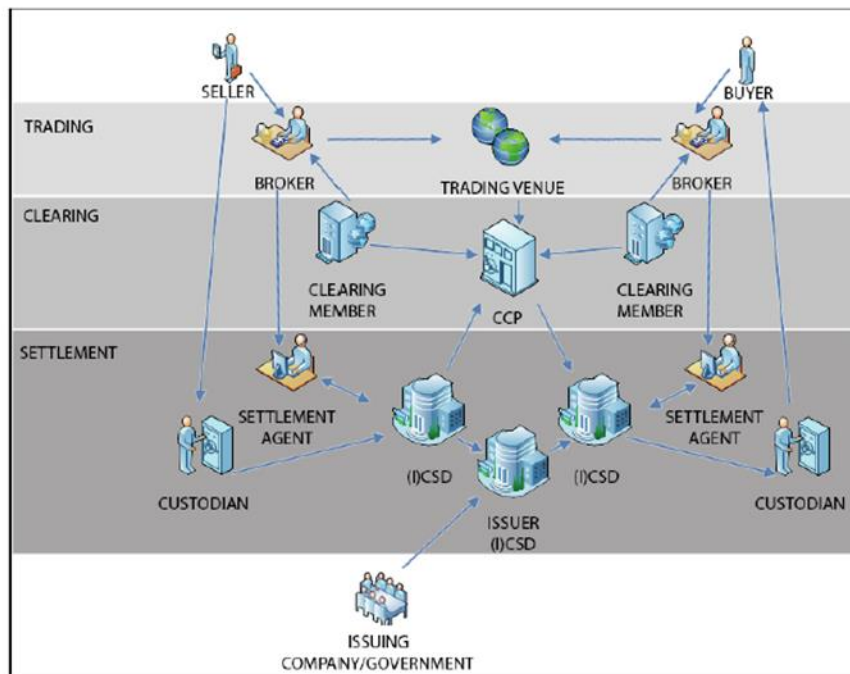


The Conflict of Laws (1/2)

- In a multi-tiered system of securities intermediation, multiple jurisdictions apply based on several connecting factors.

Diagram 1

Post-trade processes in the securities leg of current transactions



Note: (I)CSD = (international) central securities depository, CCP = central counterparty.



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The Conflict of Laws (2/2)

- In coordinating national laws, we need to ask ourselves two questions:
 - 1) To which territory is an intermediated security most closely connected?
 - 2) What conflict rule best serves the interests of the parties involved?



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a) *Lex rei sitae* Rule

- Historically, securities transactions were governed by the rules on the transfer of moveable property.
- *Lex rei sitae* is a doctrine of property law and international private law, governing the transfer of title to property dependent upon the law where the property is situated.
- Today, legal ownership of listed shares is de facto based on and evidenced by the securities account statement of the investor and not derived from physical ownership of certificates (book-entry securities).
- Securities are transferred simply by debiting the securities account of the seller and crediting the securities account of the purchaser.
- As a result, under modern systems of securities intermediation, *lex rei sitae* is rather outdated.



b) Look-through Approach

- Diversified portfolios of securities issued by companies organised under the laws of a number of different jurisdictions are very commonly used as collateral.
- Under the «look-through» approach, the applicable law is determined by looking through tiers of intermediaries to the level of the issuer of the actual certificates.
- Rules based on a «look-through» approach compel the collateral taker to determine and satisfy the perfection requirements for each of the jurisdictions where the issuers are organised. However, in a situation with changing compositions of collateral, it is impossible to manage a security interest in the portfolio.
- Additionally, where securities are held in a fungible account, there is typically no record of an individual account holder's interest in the underlying securities at the level of the issuer's register or that of any intermediary up the custody chain.
- As a result, this approach is rather impractical



c) Place of the Relevant Intermediary Approach (PRIMA)

- Against the background of the difficulties of the *lex rei sitae* and the «look-through» approach, it was suggested that the connecting factor of the conflict of laws rule should focus on the location of the account to which the interest in the securities is credited. That is the location of the most relevant intermediary (Place of the Relevant Intermediary Approach).
- The major advantage of this approach is that an investor's interest with respect to a portfolio of securities is governed by the law of a single jurisdiction.
- It was adopted in a number of jurisdictions, including the EU.
 - No comprehensive body of harmonized private international law on intermediated securities within the EU.
 - EU Settlement Finality Directive of 1998 introduced PRIMA in all European member states (Article 9(2)).
 - EU Collateral Directive of 2002 further explains the motivation for mandating PRIMA (Recital 8) and governs that any question with respect to book-entry securities collateral shall be governed by the law of the country in which the relevant account is maintained (Article 9).



d) Choice of Law

- Another and rather practical way to determine the law applicable to the rights deriving from the securities is to give that choice to the parties.
- The United States followed such a path in the Uniform Commercial Code (UCC).
- Under the UCC, the investor is fully severed from and has no direct interest in the securities.
- The only legal position that an investor holds is a *security entitlement* vis-à-vis their custodian (§ 8).
- The UCC model is functional and suited to cross-border custody chains, as the entitlement holder and the securities intermediary can choose the applicable law by express agreement.



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Considerations Made When Drafting a State of the Art Solution

- The Experts at the Hague Conference on Private International Law set out to develop a uniform conflict of laws rule to govern issues that are of crucial practical importance.
- The first Special Commission of the Convention in January 2001 considered the different approaches at hand and found that:
 - The «look-through» approach gives rise to severe difficulties in relation to securities held with intermediaries, particularly if the register is not easily identifiable with a single location.
 - There is no criterion to precisely and unequivocally determine the location of a securities account on a generally acceptable, global basis.
 - The negotiations also revealed that a state of the art solution had to move beyond the initial formulation of the PRIMA principle. It did this in two ways:
 - It abandoned the focus on attributing a «location» to an intermediary or a securities account and replaced it with an approach giving effect to an express agreement between an account holder and its intermediary.
 - It added a «Qualifying Office» requirement.



The Result: The Hague Securities Convention

- Substantive Scope

- Article 2 HSC lists issues to which the Convention applies, i.e. the issues which the law the Convention designates is called to regulate.

- Connecting Factors

- The basis for the Convention's primary rule is an express choice of law agreement between the account holder and the relevant intermediary.
- The parties' choice of law, however, will be effective only if, at the time of the agreement, the relevant intermediary has a «Qualifying Office» in the selected State.

Article 4(1) HSC (primary rule):

The law applicable to all the issues specified in Article 2(1) is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law.

Article 5 HSC (fallback option):

- (1) A Qualifying Office expressly and unambiguously identified in an account agreement as the office through which the intermediary entered into the account agreement.
- (2) Looks to the laws of the relevant intermediary's jurisdiction of incorporation.
- (3) Designates the laws in force at the relevant intermediary's place of business.



Implementing the Hague Securities Convention

- The HSC was promulgated on 5 July 2006 by the Hague Conference on Private International Law and signed by Switzerland and the US.
- In order to enter into force, the HSC needs to be at least ratified by three countries.
- Ratified by Switzerland on 14 September 2009, followed by Mauritius on 15 October 2009.
- Ratified by the United States on 1 April 2017, triggering its entry into force.



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Implementing the HSC into Swiss Law

- The Hague Securities Convention was introduced into Swiss Law in combination with the newly created Federal Intermediated Securities Act (FISA), which entered into force on 1 January 2010.
- FISA introduced the concept of «intermediated securities», which qualify neither as objects nor as claims.
- Article 3 FISA defines «intermediated securities» as 1) personal or corporate rights against an issuer which 2) are of fungible nature; 3) have been credited to a securities account; 4) may be disposed of by the account holder in accordance with the provisions of FISA; 5) are effective against the intermediary and any third party.
- The Private International Law Act (PILA) has been amended accordingly, to now be applicable to intermediated securities and their transfer.



Implementing the HSC into US Law

- Although mostly consistent, certain provisions of the HSC differ from the UCC. In such cases, the HSC as an agreement under international law, preempts the domestic law of the UCC.
- The HSC adds a significant constraint to the UCC Model through its “Qualifying Office” test.
- The “Qualifying Office” test requires the securities intermediary to have, at the time the parties choose the applicable perfection law in the account agreement, an office in the designated country.
- If the parties choose the law of any subunit of the United States (e.g. the State of New York), the «Qualifying Office» test can be satisfied by an office anywhere in the United States, not just that particular State.



Reform Discussions in the EU

- The EU is not a party to the HSC.
- By notification in the Official Journal of 25 March 2009, the proposal to sign the HSC was withdrawn.
- In April 2017 the Commission launched a public consultation on conflict of laws rules for securities transactions and claims.
- An Expert Group was established regarding the same.
- The goal is to create a comprehensive Securities Law Directive (SLD).
- The latest consultation document suggests three ways forward:
 - Leaving the status quo unchanged.
 - Targeted amendments to address specific shortcomings (clarifying “relevant account”).
 - Establishing a comprehensive conflict of laws framework (autonomously or by joining the HSC).



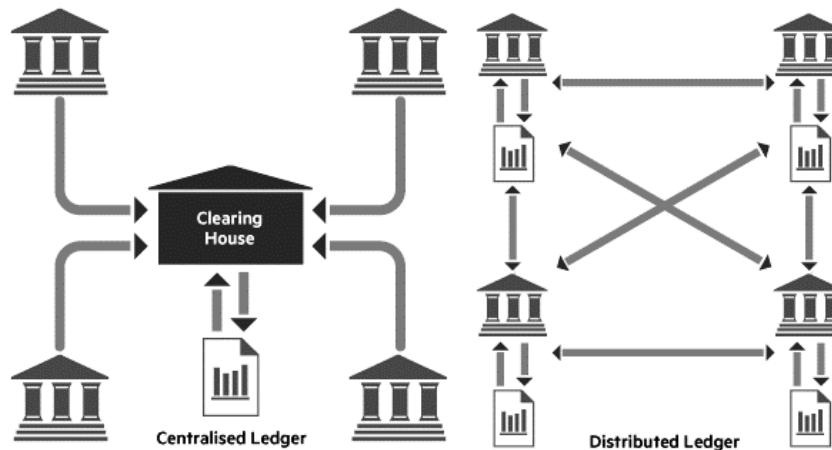
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Outlook

- Distributed Ledger Technology (DLT) could be adopted in securities trading, promising benefits in efficiency and security.
- Decentralization affects many layers in the custody chain:
 - Settlement, e.g. notary, validation and settlement finality are all questionable.
 - Custody, e.g. no custody chain, smart contracts for facilitation.
 - Clearing, e.g. netting and risk management procedures.





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A graphic with a dark blue background. On the right, a map of Europe is highlighted in a lighter blue. Several black dots are placed on the map to indicate office locations. On the left, the text 'OFFICES IN EUROPE' is written in white, with 'EUROPE' in a larger font. Below this, a list of cities is shown: Brussels, Hamburg, London, Mannheim, Munich, Paris, Stuttgart, and Zurich. At the bottom, a quote from 'The Wall Street Journal' is displayed in white and yellow text: 'A GLOBAL FORCE IN BUSINESS LITIGATION'.

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