Myths about the Hague Convention debunked

The Hague Securities Convention has come under attack for being allegedly US-centric and interfering with EU legislation. These assertions are unfounded, argue Harry C Sigman and Christophe Bernasconi

States around the world are engaged in their internal processes to prepare for becoming parties to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary. Plans are being discussed, in particular by Switzerland, the US and possibly Japan, for signing the Convention in the coming weeks or months. As regards the European Union, the European Commission is engaged in a study of a limited number of legal aspects of the Convention.

The European Council triggered this study mainly as the result of various assertions and questions raised about the Convention – primarily from within one state and one EU-wide financial oversight body. If meritorious, these assertions and questions would cast a cloud over the Convention. This development is surprising, as all then-member states of the EU (as well as the European Commission and the European Central Bank) actively participated in the preparation of the Convention, all those member states joined in the unanimous approval of the final text of the Convention, and the majority of EU member states continue to support the Convention and advocate prompt ratification.

The goal of this article is to examine some of the statements made about the Convention and to put to rest any doubts they might have raised. The Convention is the product of over two and one-half years of work at the Hague Conference. The process involved the unprecedented and most helpful participation (at The Hague, in several regional consultation meetings around the world and via international teleconferences) of practitioners representing securities depositories, lenders and brokers-all of the relevant market players, which served to provide clear and constant input with respect to the problems and needs of the financial world. This process ensured that the end product was both compatible with the needs and practices of the marketplace and functional in all contexts. And, of course, governments participated, through their chosen delegates, so as to reflect the positions of their Central Bank, regulators, and Justice and Finance Ministries. Academics, legal practitioners and financial market experts also participated. This unusually open, transparent and thorough process assured the development of a fair, efficient and globally functional solution.

Myth one: The Convention would interfere with enforcement of anti-money laundering laws, tax laws or other similar regulatory measures

There is no legitimate cause for concern in this regard. The Convention has no impact on existing or future regulatory measures. And this is no less true than it would have been had the Convention put forth a *lex rei sitae* rule.

As stated in the Explanatory Report, the Convention is simply a private international law (PIL) convention and "does not impose any changes on...substantive law". The Convention's limited scope is readily apparent from its Article 2, which enumerates, in an exhaustive list, *all* the issues falling within the Convention's scope (see Art. 2(1)(a)-(g)). Regulatory measures are simply not on the list. The Convention's scope limitation is reinforced by the repetition in Article 4 (the Convention's primary conflict of laws rule) that the law determined under the Convention is "applicable to all the issues specified in Article 2(1)."

> **Regulatory and supervisory powers are not within any of the issues listed in Article 2(1), and, thus, by the Convention's express terms, are not affected by the Convention**

Neither the Convention itself nor the applicable law determined under it governs or applies to any regulatory measures. This leaves untouched any existing or future regulatory regime controlling private conduct, whether towards the goals of preventing money laundering or preventing tax evasion, or assuring safe and sound business practices or minimizing systemic risk. The Convention does not contain a list of matters placed beyond the regulatory power of a contracting state, because nothing in the Convention has this effect in any context. It never would have occurred to those at the Diplomatic Conference at which the Convention was finalized to suggest insertion of such a list.

Myth two: The Convention would disempower supervisory authorities

It has been said that the Convention somehow gives the intermediary (typically an entity subject to supervision) a "right" to agree on a governing law and that such a choice necessarily has the effect of preventing any supervisory authority (we use this term to include regulatory, oversight, designating and other competent authorities) from limiting that right. This variant on myth one is equally without merit. Again, the Convention rule could have no such effect. It could no more bind a supervisory authority whose scope is independent of private law concepts than would any other private law concept (for example, *lex rei sitae*).

The Convention does not authorize or prohibit any supervisory or other governmental conduct, with the sole exception that a contracting state, by becoming a party, commits to its fellow state parties that it will not enact a conflict of laws rule that would substitute for or amend the rules of the Convention. The Convention in no way limits either the substantive scope or the geographical reach of the power of a supervisory authority - indeed, the Convention need never be consulted by a supervisory authority. It has no effect on the authority's powers.

The primary addressees of a conflict of laws regime are the courts (and this is equally true of the Convention). The effect of constraining courts, limiting

their ability and motivation to apply a law different from that prescribed by the Convention - an effect on which the contracting parties and third parties globally all rely - is to enhance predictability with respect to the applicable law, thereby giving marketplace participants *ex ante* certainty in ordering their affairs, and to maximize stability on which economies depend.

The Convention does not authorize or prohibit private conduct. It does not allow private persons to enter into an agreement otherwise prohibited to them by other law. For example, a minor or other person lacking capacity under national law to enter into a binding agreement is not empowered by the Convention to enter into an account agreement having any consequences. The Convention is not a grant of power to contracting parties-it simply provides for a consequence to behaviour that they may or may not engage in. The parties' power to choose the law applicable to contractual issues has a venerable history and has never been understood as limiting regulatory powers. The Convention simply has the effect of extending for PIL purposes that choice of law agreement to the list of issues specified in Article 2(1). Nothing in this suggests a limitation of regulatory powers.

Thus, it is clear that supervisory authorities are, in the exercise of their authority, free to prohibit intermediaries from choosing any governing law, or choosing a particular governing law, or choosing a governing law other than the law specified by the authority, or from taking any of these courses of action in a specified class of transactions. Further, regulators and securities system operators are free to impose any of such actions as a condition to participation in a system or to classification of obligations as acceptable for meeting credit standards (for example, "eligible bank loans" in the Single List of Collateral in the Eurosystem Collateral Framework), or as a qualification for "designation" or in any of a myriad of other contexts. For example, the supervisory authorities may require that the member state's law chosen to govern a system (under Article 9(2) of the Settlement Finality Directive) must also be chosen as the relevant law for purposes of the Convention with respect to interests in securities held or settled within that system. It should be noted that the Convention's lack of impact on such supervisory power stems directly from the Convention's narrow scope of application and is not dependent on Article 11 of the Convention.

The obligation of a court of a state party is to apply the Convention's rules whenever the Convention is applicable. If the account agreement does not have a governing law choice that satisfies Article 4, an Article 5 fallback rule must be applied. Nothing in the Convention specifies or even suggests that Article 4 embraces only completely unconstrained voluntary choices made by intermediaries. No judge would have incentive or authority to inquire whether a particular agreement's choice was, for example, dictated by a supervisory rule requiring regulated intermediaries to select a single or a particular governing law in its account agreements. There might be good regulatory reasons for such requirements, but the existence and sufficiency of such reasons are irrelevant to the application of the Convention.

The fact that the Convention's rule goes beyond the EU's interim PRIMA formulation, however, does not suggest that it is inconsistent with the EU policy determination made in the Directives

Myths one and two reflect a complete misunderstanding of the Convention's purpose and scope. Regulatory and supervisory powers are not within any of the issues listed in Article 2(1), and, thus, by the Convention's express terms, are not affected by the Convention. Furthermore, it is not necessary to interfere with regulatory measures or supervisory powers to achieve the goal of providing certainty to the financial sphere with respect to the applicable law governing the Article 2(1) issues. It cannot be asserted in good faith that there is the slightest risk that any judge could misinterpret the Convention so as to allow it to interfere with enforcement of regulatory measures or exercise of supervisory powers.

Myth three: The Convention would displace an existing successful European PIL regime

This is simply not a valid ground for the EU and its member states to refuse to become parties to and support the Convention.

The marketplace for securities held with intermediaries and for secured credit supported by such securities is global, not regional. The relationships between financial institutions and central securities depositaries in Europe, on the one hand, and their counterparts elsewhere in the world are vital to the success of each. The global need for smooth and reliable cross-border flows of capital is clear. There is no basis for singling out transactions involving Europeans (or even, if they could be so identified and isolated, "purely" European transactions) and to apply a special conflict of laws regime to them. Even if it were true that a successful PIL regime exists in Europe with respect to securities held with intermediaries, Europe has a vital stake in the success of the Convention in achieving its global goal. While it is understandable that the focus of the European Central Bank is regional, the focus of the EU and its member states in this regard should be global.

In any event, it is not true that a single PIL regime (much less a successful one) exists today in Europe. The closest thing to a European PIL regime is the combination of rules in the 1998 Settlement Finality Directive and the 2002 Financial Collateral Directive. Article 9(2) of the Finality Directive points to the law of a member state in which is located the "register, account or centralized deposit system" on which the right of specified collateral takers is "legally recorded". Article 9(1) of the Collateral Directive points to the state (which need not be a member state) "in which the relevant account is maintained". With respect to both their personal and substantive scope of application, these Directives are not identical and are each limited (for example, neither Directive specifically covers unencumbered book entry securities). Furthermore, they have not been uniformly implemented in all member states. Moreover, several member states have not uniformly exercised their powers to develop national PIL rules covering matters outside the limited scope of the Directives.

In addition, it is important to keep in mind that the "place where the account is maintained" formulation of the relevant connecting factor for the conflict of laws rule, to the best of our knowledge, has not yet been tested in the courts, so it is far from clear that it would be workable when difficult facts are presented, and

that it would be applied uniformly and predictably. Such an outcome might be years from final determination. Litigation (both as to meaning of the formulation and determination of disputed facts) is likely to be far more frequent under the "place where the account is maintained" formulation than under the "law expressly agreed" formulation embodied in the Convention.

It certainly cannot be said with confidence that this state of affairs is a proven clear and uniform regime that provides greater certainty and leads to less litigation than would be the case under the Convention.

Moreover, when the European Parliament and Council adopted the Collateral Directive, they were aware that the Hague Conference deliberations were continuing and that the ultimate formulation of the Convention's primary rule, even if related to the relevant intermediary, might differ from the draft then under discussion. Earlier in the development of the Collateral Directive, there had been proposed a specific definition of the state "in which the relevant account is maintained" formulation. This proposed definition was omitted so as not to pre-empt the work at the Hague Conference. Thus, the Collateral Directive was not intended as a declaration of final adoption by the EU of the the PRIMA (Place of the Relevant Intermediary Approach) rule as it then was under discussion at The Hague, but rather intended as an interim rule pending agreement at The Hague on a more refined rule at the end of deliberations. Furthermore, it is clear that when the EU member states signed the Final Act of the Diplomatic Conference in December 2002, they were well aware (as were the Council and the Commission) of the prospective need to modify EU legislation to align it with the Convention. Indeed, given the history of member state and Community actions with respect to the Convention, it is legitimate to consider whether an abandonment of the Convention at this point would not raise issues of credibility of the European Community as a negotiating partner with respect to global treaties generally.

The fact that the Convention's rule goes beyond the EU's interim PRIMA formulation, however, does not suggest that it is inconsistent with the EU policy determination made in the Directives. The Directives adopt the focus on the centrality of the relevant intermediary (and clearly reject all of the previously used fictitious locations, such as the place of incorporation of the issuer or the place where the register of holders is maintained). The Convention's rule retains from the PRIMA concept the notion of the centrality of the relevant intermediary, although it has gone beyond it in not seeking a *situs* of the intermediary but rather the law governing the account agreement as expressly specified by the relevant intermediary with the concurrence of the account holder.

It is absurd to think that the members of the Hague Conference would have had even the remotest willingness to provide US intermediaries with any competitive advantage in the marketplace

Myth four: The Convention is designed to work only with the substantive law of the US

Given the composition of the Hague Conference and the active participation of 44 states in the negotiations leading to the Convention, as well as representatives of numerous financial interests from all over the world, it is surprising that anyone would assert that there was agreement on an instrument that could work only on the basis of the law of a single state. As the Explanatory Report makes clear, a substantial effort was made to formulate a text that would work with all legal systems and all the variations to be found within each system. This is true as to both the Convention's terminology (terms having special meanings in particular systems were avoided) and its systematic approach. Particular provisions were included in the Convention to take into account special needs of particular legal systems or particular operational systems (see, for example, Article 1(5), drafted with the UK's CREST system, in mind). Indeed, it became clear over the course of the preparation of the Convention that there exists a great diversity of substantive laws round the globe, that in many states the same rules do not apply to domestic securities as apply to foreign securities, and that the diversity does not break down neatly between civil and common law. Not only are there significant differences between the laws of the UK and the US, but there are also great differences even among the laws of the various continental European states. Indeed, what is common to all the EU Member States is an absence of clear and uniform rules with respect to foreign securities and cross-border transfers.

As the Explanatory Report makes clear, the rule adopted by the Convention does not reflect any particular power that the US had in the deliberations, but rather the simple fact that, after much discussion, fact-finding and widespread consultation, it became clear that, given the realities of the operations of intermediaries in today's globalized marketplace and current technology, there exists no other criterion, acceptable on a global basis, objectively and realistically to precisely determine with certainty the location of a securities account or the office at which an intermediary maintains the account.

Further, the neutrality of the Convention is one of its strengths. That neutrality will enable the Convention to function in a changing context. Whatever the substantive law may be today, it might be different tomorrow. The European Commission has organized a reform project called the Legal Certainty Project. Unidroit is in the course of a reform project and has prepared a Preliminary Draft Convention on Harmonized Substantive Rules regarding Intermediated Securities; and individual states are engaged in studying the need for reform (see, for example, efforts in Canada, England and Switzerland). These efforts, of course, do not dispense with the immediate need for a clear and globally workable conflict of laws regime.

Myth five: The Convention is an attempt by US intermediaries to gain an advantage over European intermediaries

An extension of myth four, this is no more than an attempt to attack the Convention by an appeal to anti-American sentiment. It is absurd to think that the members of the Hague Conference and the industry observers who participated in the negotiations would have had even the remotest willingness to provide US intermediaries with any competitive advantage in the marketplace. The Convention is neutral in its impact. The idea that a potential account holder would have such leverage over a European intermediary as to be able to force that intermediary to agree

to the law of a state of the US (particularly given the likelihood that doing so might not only create operational problems for the intermediary but also put it into breach of other commitments and render it ineligible to participate in various systems of which it was a member) is far-fetched. To the extent that a result of the Convention's rule might be the more frequent selection of the law of a state of the US rather than the law of an EU member state as the governing law, this does not inherently produce any particular competitive advantage for American financial institutions (this point is analyzed in more detail in Bernasconi/Sigman, *The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (Hague Securities Convention)*, Uniform Law Review 2005-1/2, pp117 - 140, at p127). Moreover, it should be noted that there is nothing today that stops an investor organized under the law of an EU member state that wishes to have an account agreement governed by New York law from going to New York and opening an account there with any intermediary that would agree to New York law as the governing law.

Myth six: The Convention lacks transparency because of its use of the account agreement as the determining element

The complaint has been made that the Convention is undesirable because the primary rule (and the first fallback rule) look to the account agreement, which is not a public document. The relevant information, however, is both objective and available to those wo are entitled to it.

To begin with, investment information is not generally a matter of public record. Indeed, it is usually private information protected as confidential by professional secrecy or more general confidentiality requirements. Third parties do not generally have the right to know what assets an investor has or where it has them.

A potential collateral taker will, of course, have no difficulty obtaining from an investor seeking to encumber its property a copy of the account agreement and, if requested, authorization to the intermediary to confirm the governing law arrangements and additional detailed information. If the collateral taker uses a control agreement as the method for perfecting its security right under the applicable substantive law, it will be dealing directly with the intermediary, who will, with the consent of its account holder, readily supply a copy of the account agreement (or otherwise confirm the existence and content of a choice of law clause to the satisfaction of the collateral taker). If, on the other hand, the collateral taker perfects its security right by the method of having the securities transferred into its account, the collateral taker is disinterested in and unaffected by the content of the collateral giver's account agreement, and need only rely on the applicable law as determined by its own account agreement with its intermediary.

There is no reason why the Convention should provide special assistance to creditors seeking to seize the investor's assets, and this is particularly true if that assistance were to be derived at the expense of the efficiency and stability of the financial marketplace. Why would it be sound policy to elevate the interests of occasional levying creditors over the interest of all actual collateral takers? Would facilitation of attachment promote systemic stability?

Finally, to the extent that the PIL rule for third party rights with respect to an assignment of a claim is the law governing the underlying claim, that rule does not seem to be criticized for lack of transparency, despite the fact that it turns on facts that are not available on a public record and might well be far more complex for a third party to ascertain than the Convention's rule of simply looking at the account agreement.

Myth seven: The Convention's PIL rule and the Convention's broad scope of application under Article 3 would lead to increased costs

The opposite is likely to be true. In the mix of systems confronting market participants today, it is necessary to ascertain which of several conflict of laws rules a particular state uses in the case of intermediated securities. Often, this is, even today, still unclear. It is this very situation that inspired the Hague Conference effort that culminated in the Convention. Further, after that difficult legal determination has been made, it is then necessary to incur additional costs to ascertain the facts relevant to the application of the conflicts rule in question. Moreover, in the current situation, a prospective pledgee might be confronted with an insurmountable problem when the desired collateral consists of an account that includes a broad spectrum of securities, as this might invoke the application of numerous differing conflict of laws rules, which, in turn, might invoke the applicability of numerous differing substantive law rules. This is further exacerbated if the borrower wishes to be able to trade, so that the portfolio is of changing content. Because the Convention rule points to a single state's law to govern the Article 2(1) issues for all the securities in a single account, the Convention will produce dramatic savings in the cost of ascertainment and compliance with applicable law.

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In sharp contrast to the present legal situation, the Convention provides a single, clear and easy-to-apply primary rule: the law expressly chosen to govern the account agreement. The costs of ascertaining that single fact are nil, as the account holder who is the collateral giver readily provides a copy and authorizes its intermediary to provide a copy or otherwise confirm the material fact. Further, depending on the technique used by the collateral taker to perfect its position, the Convention rule provides legal support at no additional cost. For example, the collateral taker will often rely on the crediting of the collateral securities to its own account held with its intermediary (the collateral taker is aware of the governing law chosen in its own account agreement), or will rely on a control agreement made directly with the collateral giver's intermediary (and, thus, again, will have no difficulty ascertaining and confirming the law chosen in the account agreement between that intermediary and the collateral giver).

The breadth of the Convention's scope of application under Article 3 makes it less likely that there will be any doubt of its applicability to a particular fact situation, thus decreasing costs. Also, as the Convention is simple and virtually cost-free to apply, it will no doubt often be

"applied" by the pledgee, in the sense of ascertaining the result that would ensue from its application, and then, as a safety valve, acting to comply with the law determined to be applicable under the Convention rule. This will add absolute backup certainty at virtually no cost, even in a case, assuming such a case were to exist, where there was a doubt whether a transaction fell within the scope of application of the Convention. Therefore, the Convention's broad scope under Article 3 is a clear advantage.

Myth eight: The Convention would override public policy

Concerns asserted with respect to public policy issues are sometimes couched in terms of criticism of the Convention's primary rule on the ground that it utilizes the choice of the parties to the account agreement as the relevant factor in determining the applicable law. These assertions rest on the assumptions that private choice must be inimical to the public interest and that a mere financial matter must always be of less importance than any other governmental interest. Both of these assumptions are without merit.

It should be stressed that when, for example, the securities are transferred to a collateral taker, the parties whose agreement determines the law applicable under the Convention (for example, to the perfection and priority of the pledge) are not the collateral giver and the collateral taker, but rather the account holder and the relevant intermediary. Thus, the Convention does not enable the pledgor and the pledgee, by their collateral agreement, to adversely affect the pledgor's other creditors by choosing a law that is detrimental to those creditors (it should be observed that it has long been the law, universally, that a pledgor of a certificated directly-held security can by agreement with the pledgee achieve the applicability of a particular state's law, with third-party effects, simply by delivering the certificate to the pledgee in the agreed state). In addition, efficiency reasons support the use of the account holder or relevant intermediary's choice for determining the applicable law governing the Article 2(1) issues, including producing the likelihood that contractual, proprietary and other material issues will all be governed by the same law. These reasons are explained more fully in the Explanatory Report.

Moreover, it cannot be said categorically that private choice is inimical to public policy. Indeed, the idea that private choices have an impact on third parties is not unknown in Europe in this context. The Finality Directive requires, as a condition to "designation", that the participants collectively agree that the system be governed by the law of a single member state, leaving it up to them as to which state's law to choose (see Article 2(a), second indent, of the Finality Directive). The proposal for the Collateral Directive included a definition of where an account is maintained based on the office or branch "indicated" in the account agreement.

The second assumption ignores the governmental interests in these financial matters. Firstly, a state has a strong interest in supporting economic development (by enabling its debtors to obtain credit efficiently and inexpensively) and in supporting the strength and stability of its creditors and financial institutions generally (for example, by enabling lenders to more easily comply with standards such as those imposed under Basel II and making the entire banking and financial sector more stable and efficient). Secondly, in many ways, including the role of its central banks (for example, as provider of collateralized credit for monetary policy and payment systems, and ultimately as lender of last resort), the state itself has a powerful interest in supporting the certainty in the marketplace promoted by the Convention. This is not a case of private versus public interest. The Convention itself represents a clear decision by the state that the public interest resides in enforcement of the Convention's rule. Indeed, Article 11 is crafted to make clear the determination that individual judicial discretion should not override this public policy decision by rendering unreliable the enforcement of the Convention's rule, thereby upsetting the balance of governmental interests reflected by the legislator's decision to ratify the Convention.

The Convention itself represents a clear decision by the state that the public interest resides in enforcement of the Convention's rule

Myth nine: The Convention rule increases the likelihood that a court will have to apply foreign law

All PIL rules presuppose the possibility of a court having to ascertain and apply foreign law. This is not, in and of itself, a bad thing, nor an unusual task. Indeed, the Convention is an expression of confidence that courts are capable of performing that task. In any event, the likelihood of application by a court of foreign law is the product not of the Convention but of the increase in cross-border transactions and the global reach of intermediaries.

This myth appears to be based on the premise that intermediaries will agree that their account agreements shall be governed by the law of a state that otherwise would not be the state where they would probably be subject to jurisdiction in a seizure proceeding. Both rationality (including operational considerations, commitments to others and regulatory constraints) and the Qualifying Office requirement in Article 4 suggest that this is an unlikely premise. ■

The text of the Securities Convention is available on the website of the Hague Conference at www.hcch.net. The Explanatory Report on the Convention was prepared by Roy Goode, Hideki Kanda and Karl Kreuzer, with the assistance of Christophe Bernasconi (Permanent Bureau); copies of the Report may be ordered via the Hague Conference website.

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