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The HCCH 2006 Securities Convention: Possible Future Work

I. Introduction

1 The *Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary* (HCCH 2006 Securities Convention) entered into force on 1 April 2017. The Convention currently has three Contracting Parties. Switzerland and Mauritius ratified the Convention in 2009, followed by the United States of America (USA) in 2016.

2 In March 2021, the Council on General Affairs and Policy (CGAP) mandated the Permanent Bureau (PB) to continue to make arrangements for the 2022 Commercial and Financial Law Conference.[1] In fulfilling this mandate, the PB recalled Conclusion and Recommendation (C&R) No 44 adopted at CGAP's 2019 meeting, when CGAP invited the PB to assess reasons why parties have not joined the Securities Convention. This Preliminary Document addresses the background and relevant discussions on the Securities Convention and suggests possible topics and areas for future work.

II. Background of the Convention

3 The Convention addresses the result of the transformation that intermediation brought to the market for securities. Historically, interests in securities were represented by certificates or book registers. Courts used the traditional private international law (PIL) rule for property, the *lex situs* or *lex rei sitae,* to determine the law applicable to these physical manifestations of the rights in the securities.[2] Over the last century, new systems of holding securities came to predominate. Certificates began to be stored with a Centralised Securities Depository (CSD) and held through chains of intermediaries that debit and credit securities accounts on behalf of investors and other intermediaries. This system thus involves the intermediation and dematerialisation of securities, meaning that there is no need to physically move certificates or alter official registers.[3] This system is time, cost- and resource-efficient, and results in overall efficiency gains in increasingly globalised capital markets.[4]

4 However, there were concerns that the intermediation and dematerialisation of securities undermined the legal certainty and predictability provided by the traditional approach to PIL for securities based on the location of the physical certificates or registers.[5] Three factors exacerbated these concerns: (a) intermediaries operating in several jurisdictions, (b) multiple tiers of intermediaries recording the holdings of any given security, and (c) investors increasingly holding portfolios containing many different securities. As a result of these factors, the number of jurisdictions the laws of which might apply quickly proliferates. By the turn of the century, a global solution to the PIL issues related to intermediated securities was becoming increasingly urgent.[6]

5 Against this background, the Special Commission on General Affairs and Policy, held from 8 to 12 May 2000, unanimously approved a joint proposal from Australia, the United Kingdom and the USA[7] suggesting that the HCCH develop a Convention on the law applicable to interests in and

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1 "Conclusions and Decisions of the Council on General Affairs and Policy of the Conference (1-5 March 2021)", C&D No 38, available on the HCCH website www.hcch.net under "Governance" then "Council on General Affairs and Policy" then "Archive (2000-2021)".

2 G. Morton (2020), "The 2006 Securities Convention: Background, Purpose and Future", *The Elgar Companion to the Hague Conference on Private International Law*, p. 337.

3 *Ibid*. at 338.

4 *Ibid*.

5 *Ibid*. at 339.

6 *Ibid*.

7 "Conclusions of the Special Commission of May 2000 on General Affairs and Policy of the Conference", prepared by the Permanent Bureau, Prel. Doc. No 10 of June 2000 for the attention of the Nineteenth Session, Annex VI, reproducing Work. Doc. No 1, p. 1, on file with the PB and available upon request.

dispositions of securities held with an intermediary.[8] The rapid pace of the drafting and negotiation process that followed, involving the Member States and representatives of the finance industry, was unprecedented. The final text of the Securities Convention was adopted in December 2002 at the Nineteenth Session of the HCCH.

6 The HCCH 2006 Securities Convention is the first instrument of its kind to provide for a uniform PIL rule to govern issues related to holdings and dispositions of intermediated securities such as the legal nature and effects between account holders, intermediaries, and third parties in relation to debits and credits in securities accounts, the requirements for perfection of interests in intermediated securities, and priority disputes when interests in securities are taken as collateral.[9]

7 The Convention's primary PIL rule, as provided in Article 4(1), supports an express choice of law agreement between the account holder and the relevant intermediary. However, the parties' choice of law will be effective only if the relevant intermediary has, at the time of the agreement, an office (or an office of a third party acting for the relevant intermediary) in the selected State that serves certain specified functions relating to securities accounts, or that is otherwise engaged in a business or other regular activity of maintaining securities accounts.[10]

III. Challenges and opportunities in relation to the HCCH 2006 Securities Convention

8 The Convention has, to date, only three Contracting Parties. There was also a delay before its entry into force. In the interim, technological advances, particularly in the form of distributed ledger technology (DLT), have enabled new forms of holding securities. These have further complicated the outlook for the Convention's role in securities markets.

9 Despite the European Commission's efforts to lay the groundwork for its Member States to ratify the Convention,[11] Member States of the European Union (EU) continue to rely on the existing "Place of the Relevant Intermediary Approach" (PRIMA), currently in place in the Settlement Finality Directive,[12] the Financial Collateral Directive,[13] and the Winding Up Directive.[14] The HCCH 2006 Securities Convention, however, goes beyond the EU's PRIMA approach: In order to guarantee the necessary *ex ante* legal certainty and predictability with regard to the applicable law, the framework of the Convention takes into consideration the practical difficulties in locating an account at one place with precision. Nevertheless, at least one commentator has argued that both approaches are similar in that they look to a single relationship between the account holder and the intermediary as the critical connecting factor.[15]

10 Another concern that has been expressed by some commentators is that the Securities Convention's primary rule finds itself too far on the side of party autonomy. However, an account holder's freedom in choosing a governing law for their account agreement with the relevant intermediary is subject to the intermediary's consent, thereby limiting the parties' actual freedom

8 *Ibid.*, pp. 30-31.
9 The full list of issues within the scope of the Convention appears in Art. 2(1)(a)-(g).
10 This limitation on the choice of governing law in the account agreement is known as the "qualifying office test".
11 European Commission (2004), "Communication from the Commission to the Council and the European Parliament – Clearing and Settlement in the European Union – The Way Forward", COM/2004/0312.
12 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, Art. 9(2).
13 Directive No 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, Art. 9.
14 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, Art. 24.
15 M. Ooi (2019), "Rethinking the characterization of issues relating to securities", *Journal of Private International Law*, Vol. 15, Issue 3, p. 582.

of choice. In many cases, the intermediary will also be compelled to limit the account holder's freedom of choice due to regulatory and practical considerations.[16]

11 In relation to such regulatory matters, one misconception encountered in early debates about the HCCH 2006 Securities Convention was that it would inhibit the application of anti-money laundering laws and tax laws.[17] However, as the Convention is a purely PIL instrument, the Convention has no effect on the public authorities tasked with enforcing laws related to anti-money laundering and to tax. The Convention applies only to the exhaustive list of issues contained in its Article 2.[18]

12 Looking forward, the advent of DLT applications in capital markets means that securities are now capable of being held, transferred, cleared and settled on a blockchain. This may have implications on the continuing relevance and future increased accessions of the Convention. On the one hand, blockchains are not securities intermediaries and so, strictly speaking, the Convention does not apply to securities traded through them. On the other hand, more widespread implementation of DLT systems and crypto securities may further complicate the PIL issues in this area. For example, transacting in securities held on a blockchain may involve recording transactions in many jurisdictions across the world. Moreover, some commentators have noted that holding and trading securities via DLT is in fact similar to the systems of direct holding that preceded intermediation,[19] and point out that, just as intermediation has never completely replaced direct holding, DLT-based securities are unlikely to entirely replace the intermediated holdings system.[20]

13 The PB will continue to study the current and future role of the Convention, especially in the context of the increasing digitisation of the global economy and the potential layer of complexity added by novel DLT use cases.

IV. Possible topics for inclusion in the programme of the 2022 Commercial and Financial Law Conference

14 The PB has collated the following list of possible topics for inclusion in the programme of the 2022 Commercial and Financial Law Conference. This list is by no means exhaustive, but provides an overview of the issues that have been recently raised or discussed:

- Narrowing differences: How can differences between the HCCH 2006 Securities Convention's primary rule and PRIMA be narrowed to encourage accession to the Convention?
- Party autonomy: Does the Convention limit the choice parties might make in their account agreements with the relevant intermediaries? Would any limitation on the parties' choice ease any eventual regulatory concerns?
- Engagement with Centralised Securities Depositories (CSDs): Would the Convention lead to a situation where more than one law governs the proprietary aspects of book-entry securities? Would limiting an intermediary's choice of governing law to only the place where it maintains its book-entry records be sufficient to accommodate concerns about systemic risk?
- Reconceptualising rights in securities: How do States currently conceptualise rights in securities in their substantive law? In light of transactional practices, are there discussions

16 C. Bernasconi and C. Sigman (2005), "Myths about the Hague Convention Debunked", *International Financial Law Review*, pp. 31-32.
17 *Ibid.,* p.31.
18 *Ibid*.
19 S. Green and F. Snagg (2019), "Intermediated Securities and Distributed Ledger Technology", in L. Gullifer, *Intermediation and Beyond*, Hart Publishing, p. 343.
20 *Ibid*.

at the national level to reconceptualise on the basis of their relational aspects, rather than regarding securities as property that confers *erga omnes* rights? Given that securities are intermediated and held through chains of holdings in a commingled manner, should they still be considered moveable property? Can traditional legal categories of property law apply to digital and crypto-assets?

- Capitalising on synergies with the Geneva Securities Convention:[21] Given the complementary nature of the HCCH 2006 Securities Convention and the Geneva Securities Convention, what work can be done in partnership with UNIDROIT to promote the two instruments?
- Including new Members: Given the significant growth in membership of the HCCH since the adoption of the text of the Securities Convention in 2002,[22] is there interest from new Members to participate in discussions about the current trends relating to the HCCH 2006 Securities Convention and to accede to it?

V. Proposal for CGAP

15 Following the mandate given to the PB, the PB invites CGAP to consider the issues described in this document in relation to the Securities Convention, which will be further discussed in the programme of the 2022 Commercial and Financial Law Conference. The PB will continue to prepare for the 2022 Commercial and Financial Law Conference, with a view to including the questions raised in this document in the programme of the Conference.

16 The PB also proposes that CGAP consider mandating the PB to develop a promotional document on the Securities Convention, with a view to increasing its visibility and the number of Contracting Parties to it.

21 *UNIDROIT Convention on Substantive Rules for Intermediated Securities* (Geneva, 9 October 2009).

22 Since 2002, the following new Members have joined the HCCH: Andorra, Armenia, Azerbaijan, Costa Rica, Dominican Republic, Ecuador, Honduras, Iceland, India, Kazakhstan, Mauritius, Mongolia, Montenegro, Namibia, Nicaragua, Paraguay, Philippines, Republic of Moldova, Saudi Arabia, Singapore, Thailand, Tunisia, Ukraine, Uzbekistan, Viet Nam, and Zambia.