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HAGUE CONFERENCE ON
PRIVATE INTERNATIONAL LAW
CONFÉRENCE DE LA HAYE
DE DROIT INTERNATIONAL PRIVÉ

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THE HAGUE, 26 November 2004

No 28472(04)CB/HVL/LP

Dear Mr Schaub,

We recently received a copy of a letter dated 18 November 2004 that was submitted to you by the European Banking Federation (EBF) and which relates to the *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*. The letter repeats a number of points made by the EBF in a letter dated 29 June 2004 to the Council Committee on Civil Law and the Commission. The EBF sent a copy of its November letter to the Legal Sub-Committee of the Group of 30 (G30), of which Christophe Bernasconi is a member, and sent a copy of its June letter directly to Mr Bernasconi.

We would like to take the opportunity to clarify certain issues raised by these letters. First, we would like to comment on the nature of the process by which the Convention and the Explanatory Report were produced, and the extent of European involvement in this process. Secondly, we would like to call your attention to how each of the points raised by the EBF letter is addressed by the Convention and the Explanatory Report.

I. Nature of the process and European involvement

- From the very beginning (May 2000) to its end (December 2002), the Hague negotiation process has been totally *inclusive and transparent*. During both the formal and informal negotiation process, widespread consultations were held with all the Member States of the Hague Conference, including the EU-Member States, as well as with the private sector industry, including the most important European banks and other intermediaries. In particular, we wish to emphasise that the EBF participated in the two most important formal meetings held in The Hague during the negotiations of the Convention, *i.e.*, the Special Commission meeting held in January 2002 and the Diplomatic Session held in December 2002. Furthermore, the Permanent Bureau kept the EBF, together with all other observers and industry representatives, constantly informed of the results of the informal working process.

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- The Convention was adopted *unanimously*. As a matter of fact, not a single vote had to be taken during the entire negotiation process. This is particularly significant with respect to the conflict of laws rule embodied in Article 4(1): this provision reflects the common position of all the Member States of the Hague Conference, including the EU-Member States as expressly stated by their representatives at the Diplomatic Conference.
- The *Drafting Committee* was composed of an impressive array of established experts in the field drawn from the world's leading jurisdictions and legal traditions, and in particular from Europe and the civil law tradition. Indeed, twelve of the fifteen experts who served on the Drafting Committee were from Europe, and ten of them were from civil law countries. Of the remaining three members, one was from Japan (civil law tradition), one from the United States and one from Canada.
- The *Explanatory Report* has been prepared by three leading experts in the private international law of finance, Professor Sir Roy Goode of the United Kingdom, Professor Karl Kreuzer of Germany and Professor Hideki Kanda of Japan. Please note that two out of three of the Rapporteurs of the Convention come from civil law jurisdictions and two out of three come from European jurisdictions.
- The *June 2004 draft of the Explanatory Report* was sent to all the Member States of the Hague Conference, including all the EU-Member States, for comment. None of the responses received from any of the Member States suggested that the solution embodied in the Convention or the explanations provided in the Report were not legally sound or would lead to a competitive advantage of one legal system over another. Much to the contrary, the majority of comments received by the Permanent Bureau were very supportive. In addition, a number of helpful and constructive suggestions were made by several States (including EU-Member States) and allowed for further improvements in the final version of the Explanatory Report, which has been circulated to all EU-Member States ahead of the meeting of the Committee on Civil Law Matters (General Questions) held on 16 November 2004. In sum, the Explanatory Report can legitimately be regarded as a highly authoritative, inclusive and comprehensive study of Convention.
- On 15 December 2003, the *Commission* submitted to the Council a proposal for a Council Decision concerning the signing of the Hague Convention (16292/03 JUSTCIV 273).
- At its meeting on 8 March 2004, the *Committee on Civil Law Matters* (General Questions) reached general agreement in principle to sign the Convention (leaving open only the date of the signing).
- At its meeting on 16 November 2004, the Committee on Civil Law Matters (General Questions) agreed to add the proposal for a Council Decision concerning the signing of the Hague Convention to the Agenda of *COREPER* on 24 November 2004 [subsequently, it was agreed to remove the item from the Agenda of the meeting on 24 November and instead to add it to the Agenda of COREPER on 1 December 2004].

II. Answers to the points raised by the EBF

The following are the main points made in the most recent EBF letter:

- The *primary conflict of laws rule* contained in the Convention is different from the traditional PRIMA approach, which the EBF identifies as *lex rei sitae*.
- The Convention would require substantial *amendments to EC law and national laws*.
- The Convention is mainly designed for systems *following the U.S. model*, thus making

it easier for large *U.S. customers to impose U.S. law* on financial intermediaries in civil law countries.

- The Convention would *interfere with the operation of the Settlement Finality Directive (SFD).*
- The Convention would reduce the level of *investor protection* provided by civil law regimes.
- The European Community and its Member States should delay signing the Convention in order to perform a *"full impact assessment of the implications of the Convention on European banks on the one hand and on European investors on the other hand."*

These points were in fact all raised and extensively discussed during the negotiation of the Convention. The final text of the Convention reflects the results of those discussions, and the Explanatory Report fills in the necessary detail and background against which to interpret and assess the Convention.

The Convention's primary conflict of laws rule

No issue was more thoroughly debated in the process of negotiating the Convention than this one, and the solution embodied in Article 4 of the Convention clearly reflects the consensus of the Member States, including the EU-Member States.

At the outset, we wish to clarify that PRIMA was never conceived of as a mere embodiment of the traditional *lex rei sitae principle*, as the EBF is suggesting. It was always a broader and more modern concept. Indeed, the traditional *lex rei sitae* principle was expressly rejected by the Member States because it was too narrow and inflexible to provide the sort of *ex ante* certainty required by market participants and national supervisors in the context of the modern, electronic securities holding system, because of the difficulty of determining where an intangible securities account is localised.

The history of the negotiations leading to the Convention clearly reveals that there is no criterion – generally acceptable on a global basis for the vast majority of transactions – to precisely and unequivocally determine the location of a securities account or the office of an intermediary that maintains a specific securities account. *In other words, if the criterion for determining the applicable law were the location of the securities account or the location of the office where the securities account is maintained, no certainty could be achieved and such a test would invite 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.*

It is against this background that it became apparent in the course of the negotiations that the Hague Convention had to move beyond the initial formulation of the PRIMA principle in order to provide the necessary *ex ante* legal certainty and predictability. It did this in two ways: (i) 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 on governing law between an account holder and its intermediary, and (ii) it added a Qualifying Office requirement. In doing so, it adhered to the agreed rejection of rules based on *lex rei sitae* or any look-through approach, retaining the notion of the relevant intermediary and focusing on the relationship between an account holder and the relevant intermediary with respect to a particular securities account.

The need for amendments to EC law and national laws

In this respect, we wish to refer to a letter dated 26 July 2004 from the *International Swaps and Derivatives Association (ISDA)* to the Commission. Again, we wish to note that at

least half of ISDA's members are European financial institutions.[1] This letter correctly states that "[t]he Explanatory Report clarifies why the relatively simplistic formulation of the PRIMA principle set out in Article 9(2) of the SFD or the somewhat different, but still relatively simplistic, formulation of the PRIMA principle set out in Article 9 of the FCD [Directive on financial collateral arrangements] has proven, after considerable discussion and analysis, to be inadequate as a longer-term solution to the need for legal certainty in this area. […] It is uncontroversial that the Convention involves some change in existing EU measures, in particular, Article 9(2) of the SFD and Article 9 of the FCD. We believe that EU Member States were mindful of this when, as Hague Member States, they agreed the text of the Convention and concluded that it represented an improvement to the current position necessary for the further strengthening of the European financial markets. In other words, the fact that the Convention varies from existing EU measures is not a reason not to implement the Convention. The Explanatory Report clarifies why the reverse is, in fact, the case."[2]

The *Commission* recognised the advantages of the rule embodied in the Hague Convention when it stated that it would "make the necessary arrangements for the signature and subsequent accession to the Convention by the European Union and its ratification by the Member States" and "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."[3] On the other hand, it is somewhat perplexing to read the argument in the EBF letter that the Convention should not be signed if it would require changes in EC law and national laws – the whole point and indeed the fundamental value of harmonising the law at the global level is precisely to agree on a set standard to which national and indeed regional standards would then conform.[4]

Reference can also be made to the endorsement of the Hague Convention by the *G30*. As you know, in January 2003, the G30 issued its Report on "Global Clearing and Settlement: A Plan of Action" (January 2003). This Report recommends wide-ranging reform of the clearing and settlement process, including further harmonization of global legal and regulatory environments. The Report presents 20 recommendations, which, when implemented, will significantly improve the safety and efficiency of international securities markets. The commentary accompanying Recommendation 15, which addresses the need to advance legal certainty over rights to securities, cash, or collateral, states that "[f]inancial supervisors and legislators should ensure that the Hague Convention […] is signed and ratified by their respective nations as soon as is reasonably possible."[5] As you know, the G30 is composed of very senior representatives of the private and public sectors and academia from all continents, and is well-represented by Europeans.[6]

Convention designed for U.S. model and favouring U.S. customers

The EBF asserts that the Hague Convention is designed for systems following the U.S. model, thus putting into a competitive disadvantage civil law countries. We firmly reject this

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[1] See Annex 1 to the ISDA letter, where a full description of ISDA's membership is provided. In particular, it is recalled that "of the 20 primary members represented on ISDA's current Board of Directors, 10 are European institutions and all of the remainder have significant operations in Europe." While ISDA's European membership is almost as wide as EBF's, it is very inclusive, balanced and transparent when expressing the position of its diverse global membership. The July 2004 letter is a remarkable example of ISDA's inclusive, nuanced and objective process when expressing its position on the Hague Convention.

[2] ISDA letter, p. 5.

[3] Communication from the Commission to the Council and the European Parliament - Clearing and Settlement in the European Union - The way forward COM/2004/0312

[4] A similar point has already been made by John Walsh, the Executive Director of the G30, in an email to the EBF and on which Mr Bernasconi was copied.

[5] See http://www.group30.org/recommendations.php

[6] Among the current European members of the G30 are Dr Josef Ackermann (Spokesman of the Board of Managing Directors, Deutsche Bank AG), Mr Leszek Balcerowicz (President, National Bank of Poland), Mr Jaime Caruana (Governor Banco de España), Professor Gerhard Fels (Managing Director, Institut der deutschen Wirtschaft), Mr Mervyn King (Governor, Bank of England), Mr Jacques de Larosière (Conseiller, BNP Paribas) and Mr Jean-Claude Trichet (President European Central Bank).

assertion. The Convention is a pure conflict of laws convention – it is neither based on a particular model of existing conflict of laws rules nor does it affect or provide substantive law applicable to securities held with an intermediary. Thus, it has no effect on existing or future rules of substantive law, in particular related to the nature of an investor's interest in securities held with an intermediary or the requirements for creating or disposing of such an interest.

This analysis is again confirmed by the ISDA letter referred to above: "There are no grounds for the view that the Convention was mainly designed for systems following the U.S. model. The Drafting Group took enormous pains to produce rules that are neutral as between different legal and conceptual structures, and any other result would always have been unlikely given the traditions of the Hague Conference and the broad and open consultative process followed in this case".[7]

In addition, if there is any risk of "expansion of non-EU law (law of the State of New York)", it is a risk that is unrelated to the Convention and existing nowadays already: nothing currently prevents an investor based in Europe from opening an account with the New York office of a European intermediary and ask for New York law to be applied to issues such as the legal nature of the rights resulting from the credit of securities to the securities account, perfection requirements or priority issues. The relevant statement in the ISDA letter is again very telling: on the issue of favouring U.S. customers, "we would like to offer the following observations, which are supported by a clear majority of the members of ISDA's Collateral Law Reform Group: First, we are not sure why the issue has been framed in the way it has: namely, a U.S. customer having greater freedom under the Convention rules than under current law to impose its domestic law on a European custodian. If this were true (which we do not believe to be the case), then presumably the converse would also be true, namely, a European customer would find it easier to impose its domestic law on a U.S. custodian. Greater choice and freedom for customers, including European customers, would presumably not, in itself, be a bad thing. Second, we do not understand why it is thought that the Convention rules would give more power to a customer than the customer already has. Currently a customer may insist upon its domestic law applying if it wishes to do so simply by insisting that a global intermediary open an account for it in its home jurisdiction. If a particular global intermediary is unwilling to do that, the customer, whether it is a US, European or other, will normally have a choice of other intermediaries who would be willing and able to open an account for it in its home jurisdiction. This is certainly true for European customers."[8]

Convention interferes with the SFD

The EBF asserts that the "[t]he possibility to agree on different applicable laws to rights and obligations of participants in a system might increase systemic risk". Again, we reject this assertion. First, it seems highly improbable that a settlement system would agree to have the accounts held by its participants governed by different laws, given the operational complexities that would result. Secondly, if it did, its designating Member State would need to consider whether the system met the qualifying condition of being governed by the law of a Member State and whether designation would be warranted (as it has to be) "on grounds of systemic risk". Thirdly, to the extent that the relevant system was also used for delivery of EU system collateral, the European Central Bank would also need to approve it for that purpose. Accordingly, a settlement system is overwhelmingly likely in practice to adopt the same Article 4 law for all its accounts, and if it failed to do so the designating Member State and/or the ECB could compel it to do so as a condition of designation or approval.

The example given in footnote 2 of the EBF letter fails to illustrate any potential new complexity generated by Article 4 of the Convention – quite to the contrary. The example illustrates a problem which already exists and which is currently more difficult to solve than it is

[7] ISDA letter, p. 7.
[8] ISDA letter, pp. 7-8.

under the Hague test: under any system, including those designated at present, it is possible for cases to arise where a member bank's account in the system is governed by one law and accounts held by non-member banks with the member bank are governed by a different law. Under a situs-based approach, there is no way of avoiding this result where the member bank is "located" in a jurisdiction different from that of the system, whereas the Hague test gives the member bank the opportunity to avoid the mismatch if it judges that it creates unacceptable risks that it cannot control (which in practice is probably unlikely in any case).

Convention reduces Investor Protection

The EBF letter similarly provides no argument to support this assertion. The contention that "the Uniform Commercial Code (UCC) Article 8 regime has abolished the property rights of investors on securities" and has instead "established a regime of creditor rights of the investor vis-à-vis the intermediary" reflects a completely false understanding of U.S. law, according to the U.S. legal experts whom we have consulted and the various experts who explained the effects of the UCC regime at length in the context of the discussions at the formal meetings in The Hague. As the official commentary to the revised Article 8 of the UCC succinctly puts it, "Section 8-503 provides that these financial assets [*i.e.*, those that a securities intermediary is required to maintain in quantities sufficient to satisfy the claims of all holders of securities entitlements] are held by the intermediary for the entitlement holders, are not the property of the securities intermediary, and are not subject to the claims of the intermediary's general creditors. Thus, a security entitlement is itself a form of property interest not merely an *in personam* claim against the intermediary."

Also, we wish to clarify that 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 in the event of an intermediary's bankruptcy. That is a matter for each State to decide. Thus, if an investor believes that U.S. commercial and insolvency laws provide a lower level of protection in the event of an intermediary's bankruptcy compared to some other system of law, it is not for the Convention to affect that balance. Moreover, if this proposition were true, it would be inconsistent with EBF's own assertion that U.S. customers will force U.S. law on European custodians. Why would they want to do this if U.S. law offers them reduced protection against the custodian's bankruptcy?

Need for further impact studies

We respectfully submit that neither the Convention nor the Explanatory Report could ever have been finalised without the balanced and representative involvement of experts from all major legal traditions conducting a thorough analysis and careful assessment of all the legal issues. As already stated, the issues raised by the EBF were in fact all raised and extensively discussed during the negotiation of the Convention. Thus, we respectfully suggest that there is no need for yet another impact assessment and that no major benefit is to be expected from re-examining the same issues yet another time. Such a duplication of work would unduly delay the coming into force of the Convention and deprive States, their citizens and actors on the financial markets from the important benefits the Convention is designed to provide.

This is again confirmed by the ISDA letter: "The process that resulted in the Hague Securities Convention was a good one that allowed ample opportunity for many different stakeholders from a variety of legal traditions to express their views. Accordingly, the process and the end result of that process, namely, the Convention itself, deserve a high degree of respect. It is of great importance to the European financial markets that the Hague Securities Convention now be adopted as widely as possible, both by the Member States of the European Union and by their trading partners around the world. It would be unhelpful if adoption of the Hague Securities Convention were delayed due to the re-opening of questions that were fully

discussed and considered during the consultation process."[9]

III. Conclusion

It follows that (i) the EU Member States had a strong and continuous presence in the process which led to the unanimous adoption of the Convention and the Explanatory Report, (ii) the issues raised by the EBF were all raised and extensively discussed during the negotiation of the Convention, (iii) the final text of the Convention reflects the results of those discussions and the Explanatory Report fills in the necessary detail and background against which to interpret the Convention.

As a result, it is our firm belief that the EU-Member States and the Community should not allow themselves to be diverted by the EBF suggestion and from proceeding rapidly along the lines of the Commission's proposal of December 2003 as endorsed by the Committee on Civil Law Matters.

Please do not hesitate to contact us if you need any further information.

Yours sincerely,

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First Secretary

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[9] ISDA letter, p. 4.

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