A UNIFORM CHOICE OF LAW RULE FOR THE TAKING OF COLLATERAL INTERESTS IN SECURITIES: USING PRIVATE LAW APPROACHES TO REDUCE CREDIT AND LEGAL RISK IN FINANCIAL SYSTEMS

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Abstract
Traditionally, securities were held, traded, and settled in *direct holding systems* in which owners of securities were either recorded on the issuer's register or were in physical possession of bearer securities certificates. Today, most-publicly traded securities are recorded electronically on the books of a financial intermediary, which in turn holds its interest in another intermediary and/or central securities depository. These multi-tiered structures are known as *indirect holding systems,* in which there are one or more tiers of intermediaries between issuer and investor, and interests in the underlying securities are recorded by book entries in fungible custody accounts at various levels in the chain. The transfer of such interests occurs by book entry without any form of actual or constructive delivery. Credit and liquidity risks arise in the cross-border context because there is uncertainty as to which legal system's rules apply to the disposition of collateral interests in securities. This legal uncertainty may lead to increased credit and liquidity risk. This paper analyses a recent Hague Conference Report that proposes a uniform conflict of law rule for determining which law should apply to the disposition of collateral interests in securities held in indirect holding systems. This paper argues that more legal uniformity across national systems is needed to devise common principles and rules for the creation, perfection, and protection of collateral interests in securities.

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1. Introduction

The globalisation of financial markets and the dramatic increase in cross-border capital flows have exposed financial systems to increased credit and market risk in part because of legal uncertainty concerning how to determine the law applicable to the taking of securities as collateral in cross-border transactions. One way parties seek to limit credit risk in financial transactions is through the provision of securities and cash as collateral. Today, most publicly-traded securities are held in multi-tiered structures composed of financial intermediaries and central securities depositories in which ownership interests in securities are recorded through electronic bookkeeping in what is known as "intermediated book-entry securities".[1] The flexibility and efficient functioning of financial markets has necessitated that securities clearance and settlement systems move away from the use of *direct holding* systems that hold securities in non-fungible custody accounts to *multi-tiered indirect holding systems* that hold securities in fungible custody accounts.[2] Traditional conflict of laws approaches that have been applied to determine the law applicable to transfers of interests in securities held in direct holding systems have proved complex and impractical when applied to securities traded in indirect holding systems, often resulting in uncertainty regarding the effectiveness of collateral as protection in cross-border transactions. Many experts have recognised, therefore, that a uniform legal framework is needed to determine which law should apply to the disposition of collateral interests in securities held in fungible custody accounts and traded in indirect holding systems.

This paper discusses how certain private law approaches in the conflict of laws may reduce credit, liquidity and legal risk in the cross-border trading of securities, and thereby promote a more efficient international securities market. Special emphasis is placed on the need to adopt a uniform conflict of laws rule that

would determine which national legal system's secured transaction law should apply to the disposition of interests in securities held in indirect holding systems. The paper will review recent efforts by the European Community, the United States and other countries to adopt a uniform rule for the taking of collateral interests in securities held in indirect holding systems. The paper then discusses and summarises a recent Hague Conference Report that recommends that all countries adopt a uniform conflict of laws rule to the taking of collateral interests in securities that would apply the law of the place of the intermediary with whom the investor directly holds its securities account. The Hague Conference Report is entitled the Hague Report on "The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems"[3] ('The Hague Report'). The Hague Report recommends either a uniform national conflicts of law rule for the taking of collateral interests in securities or a multilateral convention that would define an international property interest that collateral takers could obtain in securities held in indirect holding systems. The Hague Report proposal is an important step in providing more legal certainty in determining which national law applies to the disposition of interests in securities held in indirect holding systems.

Although the Hague Report's proposal for a uniform conflict of laws rule for the taking of collateral interests in securities would be an important step in reducing credit and market risk, this paper suggests that more uniformity across national legal systems is needed in devising common principles and rules for the creation, perfection, and protection of collateral interests in securities. Such a proposal would be difficult to implement because of important differences across national legal systems in defining juridical concepts such as ownership and property and how certain ownership interests can be recharacterised as security interests under national bankruptcy regimes. These are important issues that should be debated in an international forum[4] in which the

relevant member states of the international community should be encouraged to adopt a multilateral convention or instrument that would create uniform principles and rules for the creation, perfection, and protection of creditor's interest in securities in case of bankruptcy and insolvency.

2. Collateral in Securities Transactions

Generally, there are two essential components in collateral transactions or transfers of property: (1) the contractual element describing the parties' obligations; and (2) the proprietary element dealing with rights and interests in property.[5] Regarding the proprietary elements of transfers in securities, there are three main issue areas: (1) the creation, perfection, and enforcement of pledges over such interests; (2) the completion of a title of transfer or outright sale of such interests; and (3) the issue of priority between competing dispositions of interests in securities.[6] These proprietary aspects of a transfer of interests in securities raise important issues of how creditors and other beneficial owners of interests in securities can enforce their rights when such securities are held by financial intermediaries in indirect holding systems.

Before I review some of the conflict of laws issues and the various efforts at reform, it is necessary to review the legal concepts and terms that define collateral in common law systems. Collateral is the property, such as securities or cash, provided by a borrower to a lender to minimize the lender's risk of financial loss in the event of the borrower's failure to repay in full its financial obligation to the lender. In sophisticated financial systems, collateral is used to support financial transactions and to assist companies in managing and reducing their credit risks arising from all kinds of financial transactions, from derivatives to general bank lending. Banks also use financial instruments as collateral on the money markets where the participants balance the overall amount of liquidity provided by

central banks against transactions amongst themselves that match individual surpluses to shortages of liquidity.

At a basic level, the two main types of collateral arrangements are: (1) the 'pledge', and (2) 'title transfer'. A pledge involves the debtor providing the creditor with collateral, such as securities. The ownership of the collateral remains with the collateral giver (the debtor) but usually certain uses of the collateral are 'blocked' in favour of the creditor (the collateral taker). If the debtor fails to repay the debt, the creditor has the right to liquidate the collateral and thereby redeem a portion or all of the debt.

Title transfer ordinarily involves the debtor selling the collateral to the creditor in exchange for the loan. When the collateral is securities, the creditor (collateral taker) has a contractual obligation to redeliver equivalent securities to the debtor once the debt is repaid. A type of title transfer arrangement is the repurchase agreement, otherwise known as the 'repo' agreement. In the 'repo' agreement, the debtor agrees to sell the collateral to the creditor in exchange for the loan, and simultaneously the parties agree that the creditor will sell the collateral back to the debtor at a future date for an agreed price (the repurchase price), which typically includes the interest on the loan. If the debtor files bankruptcy, the creditor simply cancels the obligation to sell back the collateral and then sets off the value of the defaulted debt against the remaining debt owed ('netting'). In some countries, the repo agreement serves as a rational market response to the cumbersome procedures and uncertainties posed by various national bankruptcy laws that have made it difficult for creditors to obtain the full value of pledged assets after debtors had defaulted and filed bankruptcy.
There are other forms of title transfer arrangements involving securities as collateral that include: "buy/sell back transactions", "securities loans", and swap transactions using a title transfer structure. Although these title transfer arrangements do not create

a "pledge" over collateral in the technical sense, they do provide an effective security function for creditors, and should therefore be regarded as collateral transactions. In regard to cross-border securities trading, the term "collateral transaction" should be understood in a broad sense so as to encompass every transaction intended to secure outstanding credit, whether or not it creates a pledge over the property to which it applies.[7]

In addition, most legal systems adopt a broad definition of the term "pledge" that includes both possessory and non-possessory security interests, while recognising that some common law systems define the term more narrowly to mean only possessory security interests.[8] Similarly, the term "collateral" should be understood to apply to any property which is the subject of a collateral transaction. Moreover, the term "perfection" should refer to the conditions necessary to protect a "security interest" in order to make it valid against third parties. It is also important to note the different categories and classifications of securities in different contexts. In this regard, securities can be classified as "certificated" or "uncertificated", "bearer" or "registered", "physical" or "dematerialised", and even as "immobolised securities". Similarly, the term "collateral" should be understood to apply to any property which is the subject of a collateral transaction. As discussed below, the main focus will be on collateral transactions involving both "pledges" and "title transfers" because it is under these arrangements that the most significant conflict of laws issues arise with respect to the question of which legal system should govern the taking of collateral interests in securities.

3. Conflict of Laws and Indirect Holding Systems

3.1 *Direct Holding Systems*

Traditionally, most investors in securities had a direct ownership interest in the issuers of those securities, regardless of whether or not those ownership interests were recorded on the issuer's register or in the investor's physical possession as bearer securities. Securities were usually held in non-fungible custody accounts with an intermediary who had direct access to the physical certificates evidencing ownership of the security.[9] There was no comingling of interests in securities held in non-fungible accounts, and therefore it was possible to preserve the direct property right held by investors in securities traded in direct holding systems. The usual approach for determining the law applicable to collateral interests in securities held in such direct holding systems was the *lex rei sitae* or *lex situs*, which was the law of the place where the security was located at the time of the relevant transfer or disposition.[10] This rule was based on the practical necessity that the *lex situs* of a security should be that jurisdiction where an interest in a security could be enforced.[11]

Although this rule posed few complications in the case of bearer securities, the attribution of a *situs* to registered securities involves a greater degree of artificiality that is reflected in a somewhat greater variety of approaches. For example, some jurisdictions regard the *situs* of securities to be the law of the place where the issuer is incorporated. Other jurisdictions regard registered securities as located at the place where the register of registered owners of the securities is maintained, while others use a combination of both approaches.[12] Although many jurisdictions have experienced satisfactory results in attributing a *situs* to registered securities held in *non-fungible* custody accounts in *direct holding systems*, the transformation of financial markets, and in particular the computerization of clearance and settlement

systems, have radically altered the way in which ownership interests are recorded and maintained by intermediaries and central securities depositories. This has resulted in increased complexity for determining which national legal system's choice of law rule should apply to a disposition of interests in securities in cross-border transactions.

Most proprietary interests in securities are today recorded by financial intermediaries through electronic bookkeeping in what is known as "intermediated book-entry securities". These ownership interests in securities are often held through one or more financial intermediaries or central securities depositories, which are often located in different jurisdictions. Each jurisdiction has its own choice of law rule to determine the *situs* of securities held in such multi-tiered holding systems ('indirect holding systems'). To locate the *situs* (eg. the place of the securities for choice of law purposes) of such securities, many jurisdictions apply the so-called 'look-through' approach, which entails looking through the tiers of intermediaries and depositories to find one or more of the following: the jurisdiction of the issuer, the register, or the place of the registrar or of registered securities. The application of one or more of these 'look-through' approaches to ascertain the *situs* of securities held in indirect holding systems produces significant conceptual and practical difficulties.[13] The major difficulty is the practical one of attempting to apply one of the above traditional approaches to determine the *situs* of securities by looking-through the tiers of intermediaries to the jurisdiction or level of the issuer, the register and/or the actual location of certificates.[14]

3.2 *Indirect Holding Systems*

Advances in computer technology have altered the structure of securities markets and the way in which cross-border trading is processed in clearance and settlement systems. Indeed, the dramatic increase in cross-border securities trading and the large

volume of collateralised arrangements involving securities has necessitated that clearance and settlement systems accommodate the need for rapid execution of trades and the transfer of interests in securities without reference to the physical possession of certificates. This has caused much complexity concerning the application of the *lex situs* rule to electronically recorded interests in securities.

Today, most publicly-traded securities are held in dematerialised form[15] in which the security is evidenced by computerized or electronic entries in a system maintained by the issuer or by a record holder acting for the issuer. These indirect holding systems often involve multiple tiers of intermediaries between issuer and investor, thus precluding physical possession and delivery of securities in certificated form.[16] Other important features are that interests in securities are reflected on the books of various intermediaries and depositories, transfers are effected by electronic book entry, and the need to transfer the instruments in which participating interests are held rarely arises. For example, Euroclear is an indirect holding system, based in Belgium, involving a network of 2,400 participating financial institutions and intermediaries throughout Europe that engage in cross-border securities transactions.[17]

When dealing with *registered securities*, many jurisdictions continue to apply the look-through approaches to ascertain the *situs* of securities held in indirect holding systems. As discussed above, depending on the jurisdiction, this requires an examination of the various factors, including the law of the issuer's jurisdiction or the law of the jurisdiction where the securities records of the issuer (the 'register') or its official recordholder (the 'registrar') are located at the time of transfer. This task becomes especially difficult when one must examine the electronic records and entries of multiple intermediaries and depositories located in different

jurisdictions in order to ascertain where an investor's securities account is maintained and recorded. This legal uncertainty regarding the applicable law for the disposition of interests in securities held in indirect holding systems increases systemic risk in financial markets. It is therefore necessary to establish another connecting legal factor that provides certainty and stability regarding the applicable substantive law for ascertaining and enforcing collateral interests in securities held in indirect holding systems.

Traditional conflict of laws approaches relying on the 'look-through' approaches to determine the *lex rei sitae* of securities held in indirect settlement systems pose major conceptual difficulties in a legal and practical sense. For example, where a diversified portfolio of securities is provided as collateral, the collateral taker must satisfy the laws of one or more of the following jurisdictions: the laws of each issuer, the law of the place of the register, and/or the law of the place of the custodian with physical custody of the securities. Moreover, many jurisdictions do not provide a clear rule for determining which 'look-through' approach to apply; for example, is it the law of the issuer, the place of the register, or the place of the underlying securities. Even if the collateral taker knows which test to apply, it may not have been possible to obtain the necessary information to determine how to apply the test. For example, the multiple tier structure of a particular securities holding may preclude a collateral taker from discovering where a national securities depository actually stores its certificates. In some cases, it may be impossible to designate a single jurisdiction as the *situs* where the certificates of a single issue are located in more than one jurisdiction.

A consensus view has emerged amongst a number of legal experts that the proprietary effects of a disposition of securities held in a fungible custody account should be determined by the law of the place where the account is maintained, and *not* the law of any other

jurisdiction that might have applied had the underlying securities been held directly by the collateral provider.[18] Indeed, Professor Goode has argued that this analysis conforms with traditional English trust law concepts, such as the concept of equitable co-ownership of a pool of fungible securities, in which case a court would apply the law of the place of the trustee.[19] This view rejects traditional conflict of laws approaches, such as the *lex rei sitae* or *lex sitae*, or the law of the place of the issuer or registrar, as artificial. Rather, a new approach is necessary that embodies a conflict of laws rule that applies the law of the place of the intermediary with whom the investor directly holds an account. This is known as the place of the relevant intermediary approach, the essential elements of which appear in the European Union's Settlement Finality Directive and the proposed EU Collateral Directive.

4. Legal Rules Adapting To Market Changes: *The EU Settlement Finality Directive and Article 8 of the US Uniform Commercial Code*

At present, businesses face many different legal regimes for the provision of collateral, with the potential for complicated conflicts between jurisdictions and uncertainties surrounding the law applicable to cross-border transfers of securities. Many experts agree that the legal uncertainty surrounding the law applicable to the disposition of interest in securities in indirect holding systems has played a substantial role in causing past liquidity crises in financial markets.[20] The significant increase in the volume of cross-border securities transactions in recent years and the trend towards dematerialisation and the use of indirect holding systems has necessitated the development of legal rules to keep pace with changes in the marketplace. In pursuit of this aim, the Report proposes the creation of a uniform conflict of laws rule that would apply the law of the place where the intermediary is located for

determining the law applicable to taking and disposing of collateral interests in securities.

4.1 European Union Settlement Finality Directive

Some legal systems have made efforts to reduce the credit risk inherent in such transactions by adopting legal frameworks that apply in a transnational context. For example, the European Union adopted the *Directive on Settlement Finality* in 1998 (Settlement Finality Directive) that provided a legal framework for regulating payment and securities settlement systems. The Directive applies to the taking of cross-border collateral in financial transactions within the EU where such transactions involve a designated securities settlement or payment system or an EU central bank. The Settlement Finality Directive provides limited protection against the effects of EU member state bankruptcy laws by insulating collateral given to the system operators, certain system participants, and EU central banks.

Article 9, paragraph 2 of the Directive is important because it permits netting in settlement systems and clarifies the applicable law to dispositions of collateral interests in book-entry securities.[21] The Report notes that the original purpose of Article 9, paragraph 2, was to benefit only EU central banks, the European Central Bank, and certain participants (ie. central securities depositories) in designated payment and settlement systems who act as collateral takers. But a number of member states have extended these protections further to include financial market participants, as defined in a more general sense. For example, the United Kingdom Parliament proposed regulations to implement the EU Settlement Finality Directive entitled the *Financial Markets and Insolvency ('Settlement Finality') Regulations 1999*[22]. Although there was strong parliamentary support for the *Settlement Finality Regulations 1999*, Parliament refused in the end to adopt the Regulations in the 2001 Parliament primarily because of objections

raised by the legal community as to how the Regulation would be reconciled with English law.[23] The proposed UK Settlement Finality Regulations would have applied the protections of the Settlement Finality Directive to a broader range of financial intermediaries and would have adopted a broad definition of the type of securities covered by the Directive. The UK Parliament's failure to adopt article 9(2) of the Finality Directive will result in continued uncertainty as to the *situs* (legal location) of collateral interests in securities held in indirect holding systems by multiple tiers of financial intermediaries in different national jurisdictions.

4.2 European Commission's Proposed Collateral Directive

More recently, the European Commission proposed, as part of its EU Financial Services Action Plan, a Collateral Directive that builds upon the Settlement Finality Directive. The proposed Directive is intended to limit credit risk in financial transactions by creating a more uniform EU legal framework to govern the disposition of securities and cash as collateral under both pledge and title transfer structures. The proposed Directive would provide more certainty to the law applicable to intermediated book-entry securities used as collateral in a cross-border context. It would do so by expanding the scope of coverage of the Settlement Finality Directive to "any book-entry securities collateral [or cash collateral]" and the law for enforcing rights to such collateral "shall be governed by the law of the country or, where appropriate, the law of the part of the country in which the relevant account is maintained, whether or not that country is a Member State."[24] The proposed Directive would essentially adopt the law of the place of the relevant intermediary account to determine all rights and interests in collateral interests in securities held in intermediated book-entry systems. The European Commissioner for the internal market, Fritz Bolkestein, endorsed the proposed Directive by stating that "[t]his proposal would determine which law governs cross-border collateral arrangements and make it possible for

market participants to conclude such arrangements in the same manner throughout the EU".[25]

In addition, the Commission's collateral proposal contains two specific measures intended to increase liquidity in the collateral market: (1) a clear statutory regime regarding agreements permitting the collateral taker to re-use the collateral for their own purposes under pledge structures; and (2) it would allow 'collateral substitution', whereby the collateral provider can withdraw particular securities and replace them with other securities of equivalent value if the collateral agreement so provides. This proposed Collateral Directive is intended to lead to more efficient price determination, and the expected reduction in market volatility could allow companies to buy or sell securities more easily and at a fairer price.

4.3 *Article 8 of Uniform Commercial Code*

The 1987 stock market crisis led US authorities to undertake reform of Article 8 of the Uniform Commercial Code (UCC), which deals with investment securities. The 1978 version UCC Article 8 was designed exclusively to apply to direct holding systems. The liquidity crisis of the October 1987 stock market collapse exposed the legal uncertainty surrounding the application of the 1978 version of Article 8 to the modern market reality of indirect holding systems.[26] Article 8 was revised in 1994 and its most important changes include: express definition of key terms such as "securities intermediary", "security"[27] and "securities account",[28] and also provides the various duties of a securities intermediary to its security account holders. An important provision is the introduction of the concept of "securities entitlement". This new concept effectively means that an investor does not have a traceable property right to a specific security located somewhere in a vault, but instead "has a package of rights and interests against the securities intermediary with whom the

investor has a direct contractual relationship.[29] As one expert observed, a security entitlement is a form of "property interest, combined with a package of in personam rights against the intermediary".[30] Under this approach, the search for the location of a pledged interest in securities ends at the intermediary where the interest is located at the place where the account in which it is recorded is maintained. The entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom the intermediary holds the position.[31] It is an efficient approach because the investor (entitlement holder) does not take the credit risk of the intermediary's other business activities; and if the intermediary files bankruptcy, its securities holdings corresponding to customer claims will satisfy these claims before any are available to satisfy the claims of general creditors.

The proposed Collateral Directive aims to provide certainty and predictability to a narrow, but essential, area of securities transactions and provides the basis for the Hague Conference's Report for applying this uniform principle of the conflict of laws to the global arena. Similarly, Article 8 of the Uniform Commercial Code's definition of "securities entitlement" and other key terms reflects an accurate description of the unique form of property interest that is a central element to the indirect holding system. Also, the search for the location of a pledged interest in securities requires the entitlement holder to look only to that intermediary where the account is maintained for performance of the obligations.

5. The Hague Conference Report and PRIMA

The need for more legal certainty in defining which legal system's rules govern proprietary interests in securities is manifest. Indeed, The *Special Commission on General Affairs and Policy of the Hague Conference on Private International* Law recognises the need to act expeditiously in examining these issues in order to

reduce legal and systemic risk in the cross-border trade of securities. In this respect, the Secretary General of the Hague Conference has convened a Group of Experts to examine the possibility of preparing and adopting a model national law or multilateral "instrument" that would clarify the legal approach to the taking of collateral interests in securities held in fungible custody accounts in indirect holding systems. The Hague Report is designed to 'identify and illustrate the most important questions relating to' the adoption of a new instrument to govern the applicable law for determining the proprietary aspects of a transfer of interests in securities held in indirect holding systems.[32]

The Hague Report notes how structural changes in financial markets have necessitated the move away from holding physical securities certificates in direct holding systems to the more flexible system of holding securities through multi-tiered structures of financial intermediaries.[33] The Report proposes a uniform conflict of laws rule that provides that all proprietary aspects of a disposition in securities should be governed by the law of the place where the immediate intermediary (with whom the investor directly holds its account) is located.[34] This conflict of laws approach is known as PRIMA – the place of the primary relevant intermediary account. The Report suggests that the adoption of PRIMA either as a uniform rule of the conflict of laws or as a multilateral convention would improve the efficiency of securities clearance and settlement systems.[35] Furthermore, it is also important to note that PRIMA is designed not only to reduce payment and settlement risk for large companies who are participants in wholesale financial markets, but it will also benefit small and medium-sized enterprises because it will reduce the cost of collateralized lending based on securities. This might result from an increased willingness of counterparties to deal with firms possessing no, or a low, credit rating if satisfactory collateral arrangements were suggested.

The essential attribute of PRIMA is to apply the law of the place of the immediate intermediary on whose books the relevant interests are recorded to questions of creation, perfection or completion, priorities and realisation of interests in respect of securities. PRIMA subjects all the interests of an investor in a portfolio of securities to the laws of a single jurisdiction, even where the issuers and certificates evidencing such underlying securities are located in many different countries. This designation of a single jurisdiction applies *only* to the proprietary elements of the substantive law of the place of the intermediary. It does not apply to the procedural rules of the designated jurisdiction, and excludes any form of *renvoi*. Moreover, PRIMA can be viewed as a reaffirmation and appropriate extension of the *lex situs* (or *lex rei sitae*) principle, in which the location of the collateral taker's interest in securities is credited to a securities account (and the beneficial ownership of the securities themselves is most likely only recorded) where the securities account is located.

PRIMA also applies regardless of whether a transfer is made by way of sale or by way of collateral transaction, and in the case of collateral transaction, it will apply irrespective of whether the transaction takes the form of a pledge or of a transfer of title. Furthermore, PRIMA applies regardless of the legal status of the collateral provider or collateral taker; and it applies regardless of the jurisdiction in which the collateral provider, collateral taker, or any other intermediary is formed or located. Where the collateral taker serves as the immediate intermediary of the collateral provider, the law of the relevant intermediary will be that of the collateral provider. Moreover, PRIMA does not purport to change existing definitions of legal interests in collateral under the substantive law of national legal systems. Rather, the Report is concerned, not with defining the legal nature of collateral interests in securities, but with creating an efficient rule to determine which legal system's principles should govern a particular interest in securities.

As discussed above, PRIMA has already been statutorily adopted in Belgium, Luxembourg, and the United States, and it is under legislative consideration in many other jurisdictions. The European Union adopted PRIMA in its Settlement Finality Directive of 1998[36] in all member states, although implementation has not been uniform because of differences in interpretation over whether it should be applied only in relation to central banks, European Central Bank, and certain settlement system participants, or whether it should be applied more broadly to protect commercial counterparties as well. To remedy this, the proposed Collateral Directive would apply PRIMA as a general rule to all situations where collateralised securities are held in indirect holding systems.

In addition, the Report sets forth several criteria for determining the location of the relevant intermediary. In most cases, the relevant intermediary's location should be determined by *either* the address stated in the account agreement governing the relationship between the relevant intermediary and its customer, or the address stated in the most recent account statement sent by the relevant intermediary to its customer. In situations where it was difficult or impossible to determine the location of the account agreement or statement, the Report suggests other legal factors be applied, such as the statutory seat of the business entity or the law under which it has been incorporated or formed. The focus of PRIMA is on the location of the intermediary, and this test applies regardless of the legal status of the pledgor/transferor or pledgee/transferee.

The Report, however, does not extend the application of PRIMA to the law of the place of the immediate intermediary in cases of insolvency of the collateral provider. In such cases, the national bankruptcy law of the collateral provider will apply, thus introducing a significant level of uncertainty for the protection of creditor's rights in cross-border securities transactions. Moreover, the Report does not provide a specific rule to determine the

location of the Intermediary under PRIMA. Should the PRIMA be determined based on the address of the intermediary as set forth in the account agreement, or should it be based on the address of the intermediary as provided in the client's most recent account statement, and in determining the applicable law should the intermediary's status as a branch or subsidiary of an entity in another jurisdiction be taken into account. Other important issues that must be considered include the definition of securities and whether certain types of derivative instruments should be covered by the PRIMA approach. The Report leaves many of these issues unresolved until the experts committee meets at the Hague and conducts further examination.

6. Beyond PRIMA – Eliminating National Legal Obstacles By Harmonising Bankruptcy and Creditor Protection Devices

The adoption of a uniform conflict of laws rule to determine the applicable law for dispositions of interests in securities held in indirect holding systems is an important step for reducing legal and market risks in financial systems, but it does not go far enough in addressing existing differences in national legal systems regarding the creation, perfection and protection in bankruptcy of collateral interests in securities. There are significant differences in how national legal systems protect collateral interests in securities that derive from history and from the economic and social structure of nations. The diversity of practices today in national legal systems poses an obstacle to the efficient operation of global securities markets. It would appear that the increasingly seamless nature of financial markets would require certain international or uniform rules and regulatory procedures to ensure that risk is managed in an efficient manner. Moreover, the efficient regulation of risk in financial markets necessitates effective international legal standards that apply uniformly in all relevant markets. The PRIMA proposal should be taken further so that there are international legal standards that would encourage convergence

and/or a substantial degree of uniformity in the way collateral interests are created, perfected and preserved in bankruptcy in all jurisdictions.

The problem posed by differences in national legal systems is that firms must adjust to a different set of rules for each country in which they operate. This has proved to be complex and costly and has distorted the efficient flow of cross-border capital to its most valued use. Moreover, even where PRIMA seeks to apply the law of the country of the immediate intermediary, this does not guarantee recognition and enforcement of interests created and perfected in conformity with that country's laws, because transfers may still violate the perfection requirements of the laws of other countries. For example, securities registered and perfected as a non-possessory pledge in conformity with the laws of the country of the intermediary who maintains the securities account will not necessarily be recognised as a perfected interest under the laws of the country where the company issuing the securities was incorporated. This is an example of a mandatory requirement of a foreign jurisdiction that operates irrespective of the *situs* of the asset and may therefore not be displaced by the *lex situs*.

These national differences in legal systems are particularly problematic with regard to bankruptcy legislation and perfection requirements. Bankruptcy law generally aims to ensure that all creditors are treated equitably. These laws often invalidate certain transfers or transactions entered into by a debtor in favour of a particular creditor a short time before the debtor files bankruptcy because such transactions often favour that creditor at the expense of other creditors in violation of principles of law. For example, a bankruptcy trustee or liquidator normally has the power to declare invalid a debtor's transfer of an interest in collateral if such transfer occurs a short time before the debtor files for bankruptcy relief. There are important differences between national legal systems concerning the definition of whether a transaction favours

a creditor and whether it should therefore be invalidated. Such variations may deter a creditor bank from accepting a pledge of securities from a borrower in a foreign jurisdiction because foreign bankruptcy laws could have an impact on the validity of an agreement with a foreign counter party. Thus, especially in regard to dispositions of interests in securities in cross-border transactions, firms must be aware of the whole range of bankruptcy laws in economies where securities transactions take place.

Moreover, recharacterisation risk arises where a collateral taker's pledged interests in securities located in the collateral taker's jurisdiction are recharacterised as unsecured claims by a bankruptcy trustee or liquidator acting for the collateral provider in a foreign jurisdiction. This type of recharacterisation risk could happen in a number of ways in the cross-border context. For example, where pledged securities are located in the collateral provider's jurisdiction and the contract creating the pledge is governed by the law of the collateral taker's jurisdiction, and the collateral taker registers or perfects its pledged interest in both jurisdictions, the collateral provider's bankruptcy trustee or liquidator would likely have the power to recharacterise the collateral taker's pledged interests to that of an unsecured claim in order to benefit other creditors.

In addition, there are rules regarding the procedures which creditors must follow to ensure that they can enforce rights to collateral and to ensure priority over other creditors in accordance with the collateral agreement. These procedures are called perfection requirements and exist to ensure that the creditors do not illegally benefit from the collateral and prohibit further use of the collateral by the debtor. But many legal systems have complicated and impractical publicity requirements, whose origins date back centuries, to ensure that third parties are aware that the assets being provided as collateral would not generally be available in an insolvency situation. In some jurisdictions, collateral can be

liquidated immediately, and in others the exercise of rights in collateral can take several months or even longer.

It is therefore extremely important to adopt a legal regime that can minimise counter-party insolvency law risk, or recharacterisation risk,[37] and provide more certainty as to which jurisdiction's perfection requirements will be applied and enforced, regardless of whether the intermediary or any other party files bankruptcy. Such a regime at the international level would be very difficult to adopt and implement not least because national authorities are reluctant to change their legal systems in fundamental ways that affect the very notion of ownership in property and the delicate balance that exist between creditors and debtors and has evolved over the years according to a country's unique political, economic and social development.

7. Conclusion

Indirect holding systems usually involve multiple tiers of financial intermediaries and central securities depositories located in different jurisdictions who register interests in securities through electronic bookkeeping. Legal uncertainty arises, and thus increased systemic risk, because traditional conflict of laws approaches (eg. *lex rei sitae*) do not provide creditors with clear answers as to which legal system's rules for disposing of collateral interests in securities will be applied in any one transaction. This paper focused on the proprietary aspects (property interests) of transferring collateral interests in securities held in indirect holding systems in different national jurisdictions. Indeed, the Hague Report is an important step towards providing a framework for analysing the relevant legal issues involved for improving legal certainty and efficiency of global securities markets. The Report's proposal to adopt a conflict of laws rule that would apply the law of the jurisdiction of the place where the immediate intermediary is located is an important proposal that must be considered in the

global context of improving efficiency in international securities markets by reducing credit and market risk in cross-border securities trading. This paper suggests, however, that the Report's proposal for a PRIMA may not be sufficient to reduce legal and market risk in the taking of collateral interests in securities. This is because there needs to be more uniformity and harmonisation amongst national legal systems with respect to the creation, perfection, and protection of collateral interests in securities. This can be done either by harmonisation of national laws or by adopting uniform principles through a multilateral convention or treaty. Nevertheless, the objective of promoting efficient financial markets by reducing credit, liquidity and legal risks requires that such reforms be undertaken by the international community, and that relevant laws of national legal systems be amended accordingly.

Notes

[1] See R. Potok & M. Moshinsky, "Cross-Border Collateral: A Conceptual Framework For Choice of Law Situations" *The Oxford Colloquium and Conflict of Laws* JIBL (Sept. 1998).

[2] Multi-tiered indirect holding systems are composed of various financial intermediaries, such as custodians and depositories, who operate pooled or 'omnibus' customer accounts and use electronic bookkeeping to amalgamate and record the securities holdings of all their clients, such as brokers, investment managers and other investors. See Bank for International Settlements (BIS), *Cross-Border Securities Settlements,* Report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries, Basel, March 1995, pp.40-42.

[3] This Report was (subsequently referred to as "The Report") prepared by Christophe Bernasconi, First Secretary of the Permanent Bureau of the Hague Conference on Private International Law. The Bernasconi Report was a response to a call by the Secretary General of the Hague Conference to assemble a group of experts to examine the need for a uniform rule of the conflict of laws to determine which jurisdictions law will govern the proprietary elements of collateral interests in securities.

[4] International bodies that have issued reports and proposals covering these issues include the International Organization of Securities Commissions (IOSCO), the Committee on Payments and Settlement Systems at the Bank for International Settlements, and the Hague Committee on Private International Law.

[5] See discussion in Richard Fentiman, "Cross-Border Securities Collateral: Redefining Rechacterisation Risk" in *Oxford Colloquium on Collateral and Conflict of Laws* (Sept. 1998) p. 38-39.

[6] See R.D. Guynn & N.J. Marchand, "Transfer of Pledge of Securities held Through Depositories", in Hans van Houtte (ed.), *The Law of Cross-Border Securities Transactions* (London: 1999) pp. 49, 51-52.

[7] The Report, p. 9.

[8] *Ibid.* pp. 6-7.

[9] Guynn and Marchand, pp. 52-53

[10] Dicey & Morris, *Conflict of Laws* (L. Collins, ed.)(12th ed., 1993) Rule 120.

[11] If dealing with *bearer* securities, the applicable law would be that of the jurisdiction where the collateral taker takes possession of the securities certificate at the time of the transfer.

[12] This approach provides that a party's name on the register, rather than possession of a certificate, conveys legal rights to the securities. See Report, p. 27, n. 107.

[13] The Report notes that the different approaches for determining the situs of securities by looking through multiple tiers of intermediaries to determine the law of the issuer, the register or the registrar, and/or the location of registered securities or the place of bearer securities can pose

difficult conceptual and practical problems. The Report pp. 26-27.

[14] The Report, p. 27.

[15] A security in dematerialised form is a security the issue and holding of which are evidenced solely by computerised or electronic entries in a system maintained by the issuer or by a recordholder acting for the issuer. By contrast, the phrase 'physical securities' is generally used to refer to certificated securities.

[16] The great majority of these securities are held in omnibus customer accounts in which no information about the individual is recorded in the financial intermediaries and securities depositories that occupy the upper tier of these indirect holding systems.

[17] Euroclear, "About The Euroclear Group", at http:// www.euroclear.com/eoc/default.asp (visited 23 June 2001).

[18] See 'Oxford Colloquium on Collateral and Conflict of Laws' [1998] *JIBFL*.

[19] R. Goode, 'Security Entitlements As Collateral and the Conflict of Laws' [1998] *JIBFL*.

[20] See generally, F. Oditah, ed., *The Future for the Global Securities Market: Legal and Regulatory Aspects* (OUP, 1996).

[21] The Report cites Article 9, paragraph 2 as follows: "Where securities (including rights in securities) are provided as collateral security to participants and/or central banks of

the Member States or the future European central bank as described in paragraph 1, and their right (or that of any nominee, agent or third party acting on their behalf) with respect to securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities shall be governed by the law of that Member State."

[22] S.I. 1999 No. 2979, as amended with effect from 5 April 2001, by S.I. 2001 No. 997.

[23] The Parliamentary Act would have been known as the *Financial Markets and Insolvency ('Settlement Finality Amendment')*.

[24] See proposed Collateral Directive, art. 11, para. 2. See also discussion in Report, p. 52.

[25] See EU website at www.europa.eu.int/comm/internal_market /en/finances/index

[26] See James S. Rogers, "Policy Perspectives on Revised U.C.C. Article 8, (1996) 43 *UCLA L. Rev.* 1431.

[27] §8-102(a)(15).

[28] §8-501(a).

[29] The Report, p. 25.

[30] See Rogers, "Policy Perspectives on Revised U.C.C. Article 8 at pp. 1456-57.

[31] *Ibid.*

[32] As noted above, the Hague Report is entitled the Hague Report on "The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems". The Report was prepared by Christophe Bernasconi, First Secretary of the Permanent Bureau of the Hague Conference on Private International Law. The Report was a response to a call by the Secretary General of the Hague Conference to assemble a group of experts to examine the need for a uniform rule of the conflict of laws to determine which jurisdictions law will govern the proprietary elements of collateral interests in securities.

[33] The Report, p. 2.

[34] The Report is careful to define the term 'intermediary' in a broad sense to include "all the various kinds of financial institutions through which investor's interests are held, for example, brokers, nominee companies, banks and other custodians, settlement systems and depositories." The Report, p. 2 n. 6.

[35] The Report, pp. 4-6.

[36] Directive 98/26EC of the European Parliament and of the Council of May 1998 on settlement finality in payment and securities settlement systems, *OJEC* 1998, L 166/45.

[37] See discussion in Fentiman, "Cross-Border Securities Collateral: Redefining Recharacterisation Risk" in *Oxford Colloquium on Collateral and Conflict of Laws* JIBFL pp. 38-39.

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APPENDIX

Appendix A

Securities Collateralization in a Modern Holding Pattern