**The standardisation of conflicts of laws rules for intermediated securities within the EU: Holy Grail or red herring?**

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The standardisation of conflicts of laws rules for intermediated securities within the EU: Holy Grail or red herring?

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Abstract
The quest to standardise conflicts of laws rules for intermediated securities is fraught with difficulty. Whilst harmonisation will provide certainty in the market place, its critics argue that its introduction impinges on substantive rules of property law. This matter has vexed policymakers and academics for almost two decades and, despite the development by UNIDROIT of the Geneva Convention on Substantive Rules for Intermediated Securities, is at an impasse. In the light of the EU’s recent consultation on conflicts of laws rules for third party effects of transactions in securities and claims, this paper will reflect upon the discussion thus far and consider whether there is a need for overarching reform in this area of law at EU level, mindful that the EU forms only part of the global market place. Through a critical analysis of the consultation proposals, a consideration of the ‘real world’ experience of the courts and the application of complexity theory as a tool of normative reconstruction, this paper provides a new perspective to the debate and argues that, whilst some minor reforms may be appropriate, overarching reform in this area is unnecessary.

Introduction
In 2003, the European Commission proposed that the EU should ratify the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (the “Hague Convention”).¹ Six years later, following an unfavourable opinion from the European Central Bank (“ECB”),² a further legal assessment from the European Commission³ and a resolution from the European Parliament,⁴ the proposal was withdrawn.⁵ Yet the concerns that were raised, both in these discussions and in subsequent discussions concerning the substantive treatment of the law relating to

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¹ Proposal for a Council Decision concerning the signing of the Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary, COM (2003) 0783 final. According to para 7 of the Proposal, the EU is understood to be a Regional Economic Integration Organisation for the purposes of Article 18 of the Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary (hereafter the Hague Convention) and so could, potentially, sign on behalf of the Member States. The European Commission therefore asked the European Council to authorise the President to nominate a person or persons to sign the Hague Convention on behalf of the EU (see para 16 of the Proposal).
intermediated securities,\textsuperscript{6} have not been laid to rest, with the European Commission’s 2015 green paper on Capital Markets Union\textsuperscript{7} identifying the ownership of securities as an area that needed further investigation.\textsuperscript{8} In April 2017, just as US ratification brought the Hague Convention into force,\textsuperscript{9} the EU opened a consultation on the conflicts of laws rules for third party effects of transactions in securities and claims (the “EU Consultation”).\textsuperscript{10} The rationale for seeking to harmonise conflicts of laws issues in relation to intermediated securities is the perception that the legal uncertainty that flows from a lack of consistency in approach at national level is an obstacle to cross-border investment.\textsuperscript{11} The downside of harmonising conflicts of laws rules in this area is, however, that such harmonisation impinges on substantive rules of property law.\textsuperscript{12} This is an issue that has vexed policy makers and academics and has led to further work being done on the substantive issues that arise from intermediation, which culminated in the Geneva Convention.\textsuperscript{13} This paper will reflect upon the impasse that has been reached in the discussion thus far and consider whether there is a need for overarching reform in this area of law at EU level (mindful that the EU forms only part of the global market place) through a critical analysis of the options for reforming the EU conflicts of laws rules in respect of intermediated securities.\textsuperscript{14} By exploring the proposals set out in the EU Consultation with reference to complexity theory and the “real world” experience of the courts, this paper will provide a new perspective to the debate and argue that whilst some minor reforms may be appropriate overarching reform in this area is unnecessary. The impact of this paper will be derived from its role first, in contributing to the global conversation on this topic and second, in informing and influencing both the current discussion as to how EU conflicts of laws rules should develop to address the complexities thrown up by the use of intermediated securities in the financial markets, as well as the more localised debate as

\textsuperscript{6} In the development of the 2009 UNIDROIT Convention on Substantive Rules for Intermediated Securities (the “Geneva Convention”). The ECB Opinion on the Hague Convention specifically recommended that the substantive law position should be addressed and that the work of UNIDROIT (on what subsequently became the Geneva Convention) should be explored. See also the ECB Opinion para 15 (supra n. 2).


\textsuperscript{11} European Commission Action Plan p. 23 (supra n. 8).

\textsuperscript{12} Art 345 of The Treaty on the Functioning of the European Union states that the EU Treaties shall not prejudice the rules in Member States governing the system of property ownership (replacing Art 295 of the EC Treaty), although this provision is not necessarily to be taken literally according to Case C-503-99 Commission of the European Communities v Kingdom of Belgium I-4809 which held that ‘That article does not have the effect of exempting the Member States’ systems of property ownership from the fundamental rules of the Treaty’. See also A. Lehavi, ‘Unbundling Harmonization: Public versus Private Law Strategies to Globalize Property’ Chicago Journal of International Law (2015) p. 452 at p. 477.

\textsuperscript{13} See the recommendation of the ECB in its Opinion (supra n. 2).

\textsuperscript{14} This could include ratifying the Hague Convention: the European Commission’s legal assessment recommended that the EU should only consider ratifying the Hague Convention after the US had done so. See the Executive Summary to the Legal Assessment p. 4 (supra n. 3).
to how the UK should be positioning itself in the development of its own laws (here, the laws of England and Wales) as it moves into the post-Brexit era.

Structure

The paper will begin by outlining the particular issues raised by the dematerialisation of securities (whereby securities are uncertificated and held electronically rather than in paper-based form)\(^{15}\) and explain how potentially complex conflicts of laws issues may arise where dematerialised securities by an intermediary or through a chain of intermediaries.\(^{16}\)

The second part will discuss the EU conflict of laws rule of the place of the relevant intermediary approach (PRIMA), before exploring the inadequacies of PRIMA as a conflicts of laws rule. By way of background, it is necessary to appreciate that PRIMA is used to address market uncertainty in several contexts: first, within settlement systems under Article 9(2) of the Settlement Finality Directive; \(^{17}\) second in financial collateral arrangements under Article 9 of the Financial Collateral Directive; \(^{18}\) and third, under Article 24 of the Winding Up Directive.\(^{19}\)

Part three will address two matters. First, the potential solutions that have been offered to overcome the inadequacies of PRIMA; and second, the inadequacies of the potential solutions themselves in that they introduce new uncertainties for investors in intermediated securities through their interference with proprietary interests. Whilst the harmonisation of property law across Member States does not, technically, fall beyond the scope of the EU Treaties, any such harmonisation would be extremely complex to deliver, particularly as no EU-wide property norms exist.\(^{20}\)

In the context of intermediated securities, a legal relationship that might be described in contractual terms in one Member State might be described in proprietary terms in another, the critical factor for the investor being whether they will obtain priority in the event of the intermediary’s insolvency. Whilst this issue is unlikely to concern investors where an intermediary is solvent (as any successful claim is capable of being paid in full, whether brought under property or contract law), it becomes problematic where an intermediary is insolvent since, in the absence of


\(^{16}\) Note that the EU Consultation extends to conflicts of laws issues in respect of the assignment of claims (supra n. 10). Whilst much of the discussion here is pertinent to that topic, the focus of this paper is nonetheless on intermediated securities.


\(^{20}\) See supra n. 12. The question remains as to ‘whether the EU has a ground of competence to harmonise’ see K. Cox, ‘Summary of the Discussion at Leiden University’ in U. Drobnig et al. (eds.) Divergences of Property Law: An Obstacle to the Internal Market?, Sellier (2006), p. 237.
an established proprietary interest, a contractual claim may be paid only in part, or not at all. 21

Part four will apply complexity theory to the problem and demonstrate its usefulness in providing an alternative approach to the impasse that has been reached in the debate on conflicts of laws thus far. It will show that complexity theory has a role to play in moving the discussion forward through its use as a tool first, of deconstruction and second, as a tool of normative reconstruction. 22 Webb asserts that complexity theory can contribute to two of the three elements deemed necessary for social action in socio-legal theory, namely, “broadly-based theoretical understanding and systemic analysis; [and] an (empirical) knowledge of the institutions which shape and are shaped by law”. 23 In this context, the institutions that this paper will consider are the courts which are, as Sigman and Bernasconi have pointed out, “the primary addressees of a conflict of laws regime.” 24 This section will set out the author’s central thesis: namely, that in the biggest “real world” example of the failure of an intermediary (Lehman Brothers, hereafter “Lehman”), there were no English or US reported cases on conflicts of law issues arising in respect of intermediated securities 25 nor are there any reported EU cases in this area 26 which evidence supports the contention that there is not, in fact, a practical conflicts of law problem that needs resolving within the EU and the US (where there is apparently broad consensus as to outcomes), even if theoretical problems exist and particular problems may be envisaged in third countries beyond the US. 27 The point here is not that the collapse of Lehman did not cause immense problems; 28 it is that the problems (as evidenced

21 This has led to the protection of the proprietary interests of investors whose assets are held by Euroclear (Belgium) and Clearstream (Luxembourg) through legislative intervention in the form of the Belgium Royal Decree No 1962 of 1967 and the Luxembourg Securities Act of 1 August 2001 (as amended).


23 See supra n. 22.


25 The most notable conflicts of laws case was Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd, and Lehman Brothers Special Financing Inc. [2009] EWHC 1912 (Ch), [2009] EWCA Civ 1160 and as Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc [2011] UKSC 38 in which the English court concluded that the so-called “flip” clause did not breach the anti-deprivation principle whilst the US Court held that it did in In re Lehman Brothers Holdings Inc. 422 BR 407 (2010). For further analysis of the Lehman case law, see the author’s doctoral study ‘In a digital age and where significant assets may consist of dematerialised instruments, are our existing rules sufficient to provide a fair and effective regime governing the location of assets?’ Available at <https://irep.ntu.ac.uk/id/eprint/30098/1/Moffatt_thesis.pdf>.

26 See Table 3: Concrete examples on conflicts of law in European Central Bank Conflicts of Laws Issues in T2S Markets 10 November 2015 (“The T2S Study”). The T2S Harmonisation Steering Group surveyed 21 T2S National User Groups (“NUGs”) obtaining 17 out of 21 responses as well as responses from three non-T2S NUGs and EU Consultation (n 10) Question 3.


28 These are well documented: see, for example, the Basel Committee on Banking Supervision Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, see section I and section II part 4 https://www.bis.org/publ/bcbs169.pdf (accessed 1 March 2018).
As this paper will go on to discuss, the problems that arose in Lehman largely related to determining whose assets were whose; problems exacerbated by the absence of a suitable resolution regime for institutions such as Lehman. This issue has been addressed post-crisis, so that the resolution of failing banks is now essentially a matter for government authorities, within the EU under the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation. Now, a failing intermediary is likely to be bailed in or its viable business transferred on to a solvent “good” intermediary as part of a resolution process, thus preventing the level of disorder that arose post-Lehman. If a conflicts of laws problem relating to intermediated securities were, nevertheless, to come to pass following the failure of an intermediary and the implementation of the resolution process, it is hard to see how such a problem would be resolved other than through the courts. It is also hard to see why a standardised conflicts of laws rule is thought necessary, when the evidence from the Lehman litigation supports the contention that senior insolvency practitioners and judges can be trusted to address complex cross-border legal insolvency problems pragmatically and cooperatively.

Finally, the paper will conclude that an application of complexity theory yields an outcome in which it is legitimate to conclude that no changes are required to existing EU conflicts of laws rules, other than to standardise the PRIMA rule in the current iterations of the Financial Collateral Directive, Settlement Finality Directive and Winding Up Directive. Mention must be made of the Geneva Convention, which sought to resolve the shortcomings of the Hague Convention by proposing substantive law rules for intermediated securities in the absence of any EU or global property law norms. It is notable that the EU Consultation does not refer to the Geneva Convention (despite it being suggested as a potential solution in some of the responses to the CMU). A full discussion

29 See supra n. 25.
31 See supra n. 30. The new regime includes the introduction of resolution colleges for the purpose of planning the recovery and resolution of group/cross-border institutions in accordance with Regulatory Technical Standards contained in Commission Delegated Regulation (EU) 2016/1075of 23 March 2016.
32 See A. Walters, ‘United States’ bankruptcy jurisdiction over foreign entities: exorbitant or congruent?’ Journal of Corporate Law Studies (2017) p. 367. Maxwell, Lehman and MF Global all provide instances of cross-border cooperation between English administrators, the High Court in England the US Bankruptcy Court. The judiciary of EU Member States is used to cooperating effectively in the implementation of the European Insolvency Regulation (now recast) 2015/848/EU and much work is done by international organisations such as INSOL International in providing opportunities for judges to meet and share best practice. If the judiciary and senior insolvency practitioners cannot be trusted to cooperate on a cross-border basis, then there is likely to be a serious problem either at a political or regulatory level in one or more of the states involved, which might beg the questions first, as to whether existing conflicts of laws rules would be respected in any event and second, whether market participants would want to influence the development of financial markets structures that avoided such jurisdictions.
is beyond the scope of this paper but it has been criticised for its functional approach,\textsuperscript{34} which is problematic in those jurisdictions where its application may result in different rules of property law being applied to intermediated securities than are applied to other assets.\textsuperscript{35} (As Calnan observes, if different rules apply to different types of property, this will add complexity, and therefore costs, to a transaction.)\textsuperscript{36} Further, while the EU may ultimately choose to ratify the Hague Convention and/or the Geneva Convention, neither will resolve difficulties that may arise in third countries beyond the US unless those countries can be persuaded to follow suit. Nor does it make sense for the UK to implement new initiatives at a time when the UK needs to promote clear and understandable laws to third countries in order to badge itself “a country to do business with” in a post-Brexit world.\textsuperscript{37}

**Part One: the particular problems thrown up by intermediated securities**

**Background**

Intermediated securities are, essentially, debt and equity securities\textsuperscript{38} belonging to an investor and held for them through an intermediary or series of intermediaries. The investor’s interest is identifiable through a series of electronic book entry accounting records. Thus intermediated securities are held through a chain of third parties, each of which will have a different legal relationship to the underlying asset.\textsuperscript{39} Different jurisdictions have different models of intermediation and thus there are different legal analyses as to how intermediation works.\textsuperscript{40} It is beyond the scope of this article to go into detail, but the English law analysis is set out here by way of illustration.

As a matter of English substantive law, intermediation creates a trust, with the legal title to the asset being held by a trustee intermediary, who holds the beneficial interest in that asset on trust for the investor (the party in whose name the asset is credited in a securities account). To the extent that there are a number of intermediaries in the chain, the

\textsuperscript{34} This is ‘an approach using language that is as neutral as possible and which formulates rules by reference to their results’ H. Kanda, C. Mooney et al *Official Commentary on the UNIDROIT Convention on Substantive Rules for Intermediated Securities* Oxford University Press (2012) p. 5.


\textsuperscript{36} In the English law debate on secured transactions reform, Calnan argues that it makes no sense to have separate regimes for personal property and real property as a secured creditor will want security over all the assets of a borrower company. R. Calnan, R. ‘What makes a good law of security?’ in F. Dahan (ed) *Research Handbook on Secured Financing in Commercial Transactions* Edward Elgar (2015), p. 456-457.

\textsuperscript{37} This must be the case regardless of any views held about whether Brexit is a good or bad thing.

\textsuperscript{38} See for example, the definition of “transferable securities” under Article 4(1), (44) of Directive 2014/65/EU on markets in financial instruments [2014] OJ L 173/349, which encompasses shares and bonds.

\textsuperscript{39} The term “legal” is used generically. As a matter of English law, many of these interests would be understood as equitable interests under a trust.

investor’s asset is held through a series of sub-trusts corresponding to the number of intermediaries in that chain. An investor (the beneficial owner of the asset) seeking to enforce its proprietary interest in the asset would first have to bring a personal claim against the trustee. If the trustee were in fact a sub-trustee (as would be the case where the chain is made up of more than one intermediary), then the sub-trustee would have to bring a personal claim against the trustee to obtain the proprietary interest which it would then pass back down the chain to the investor (the “ultimate” account holder).

Whilst the English law analysis is relatively straightforward, the reality in the market place is that the intermediation of securities will rarely involve a single jurisdiction. In the context of a capital markets transaction in which, say, bonds have been issued, a number of intermediaries will be involved in the chain. A common depositary will hold the global note for an intermediary CSD (such as Euroclear or Clearstream). The intermediary CSD (tier one) will hold the benefit under the note for an intermediary account holder (tier two), which will hold the benefit of the note either for the ultimate investor or for a nominee who holds for the ultimate investor (tier three). In such a case, even if the issue is governed by English law, the investor will have a securities account with its nominee which may or may not be based in England; the nominee will have an account with the intermediary CSD which may be based in Luxembourg or Belgium and the intermediary CSD will have an account with the common depositary which may be somewhere else entirely.

Most of the time, markets function effectively and the solvency of trading partners and intermediaries is not in question, so the legal rules that underpin transactions involving intermediated securities are of little consequence to investors. Where losses are suffered, however, investors will look to their legal rights either to recover their property or to seek recompense for its value. This requires that the proprietary interests of investors in those securities (if any) are both recognised and upheld. In these circumstances and where assets are held across borders, the question arises as to whether the investor’s proprietary interest in the asset will be recognised and upheld by every intermediary along the chain. Where all the intermediaries are solvent, establishing a proprietary interest will be of lesser concern to the investor as it may be possible for the investor to sue its first line intermediary for breach of contract, but matters are more serious when an intermediary becomes insolvent.

41 There are other possibilities: the issuer may deposit the global or note or notes in physical form direct with the intermediary CSD. See Goode 2013 p. 234-235 (supra n. 15).
42 For examples, see the revised draft of the UNIDROIT Legislative Guide on Intermediated Securities (supra n. 40) p. 19-20.
On the insolvency of an intermediary, there are two key problems which Gullifer has described as those of “identification” and “shortfall”. The identification problem may arise when the assets of an investor are not segregated by the intermediary, but held in an omnibus (pooled) account. In this situation, it may not be clear which assets belong to which investors. Assuming that all the assets in the account can be ascribed to investors, this can lead to delays in returning assets to creditors, but is less serious for an investor than the question of shortfall. The shortfall problem will arise where the intermediary does not hold sufficient securities to match the accounting entries of each of its account holders. It may be difficult to understand how shortfalls might arise until it is recognised that the investor’s assets may be used as financial collateral by the intermediary for its own purposes. In such a case, the situation may arise whereby the assets are no longer available for the investor at the point of the intermediary’s insolvency. The effect of this is that, despite the investor having a proprietary interest in the asset, it is no longer traceable, with the consequence that the investor is merely an unsecured creditor vis-à-vis the insolvent intermediary.

Other issues

Before moving on to discuss the conflicts of laws rules in the context of intermediated securities, three further points must be noted for completeness. The first is that there are other issues that may arise for investors as a consequence of intermediation which may prove detrimental to their interests, including mistakes as to the allocation of their assets and fraudulent interference with their assets, but it is submitted that these fall within the wider ambit of shortfall (and possibly identification) issues. Micheler also notes that the agreements put in place as between each of the various intermediaries along the chain may serve to diminish the rights of the investor. Essentially this is because each agreement will set out slightly different rights and obligations to those set out in the agreement between the investor and the first tier intermediary. These may be administrative obligations or may affect the fees charged under the agreement; cumulatively, however, they may have a negative impact upon or otherwise limit the investor’s rights. This latter issue falls outside the scope of this paper as it can be seen as a matter of conduct of business regulation.

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44 Which is not to underplay the issues of systemic risk that may arise from the delays caused by the process of identifying who is owed what, evidenced in the Lehman insolvency. As discussed in the Introduction, the adoption of appropriate resolution regimes for intermediaries such as Lehman should reduce this risk in the future.
45 This may be by way of security or title transfer, see Art 3(1) Financial Collateral Arrangement (No 2) Regulations SI 2003/3226 (as amended by SI 2009/2462 and SI 2010/2993).
47 Chapter 1a of the Shareholders Rights Directive (EU) 2017/828 [2017] OJ L 132/1 introduces an improved level of protection; see, for example, Art 3d Non-discrimination, proportionality and transparency of costs.
The second point to note is the concept of the “no look through” approach which is widely adopted in respect of intermediated securities.\textsuperscript{48} This means that a party in tier 3 of a chain of intermediaries can only claim against the next intermediary in the chain (the tier 2 intermediary) and cannot make a direct claim against a higher tier (here, the tier 1) intermediary. In turn, this means, for example, that an investor cannot make a direct claim against an issuer.\textsuperscript{49} The “no look through” approach is essentially a practical one as the alternative “look through” approach would be hard to implement where intermediated securities are held in an omnibus account, as the issuer will have no record of individual investors’ interests in the securities on its register.\textsuperscript{50}

The third point to note is that, whilst this discussion has been framed on the English law understanding of intermediated securities and interests therein as a form of property, other jurisdictions may view them as obligations or even as \textit{sui generis}.\textsuperscript{51} Some have questioned whether the problems of intermediation can be resolved simply through an application of property law concepts,\textsuperscript{52} hence the movement towards the functional approach taken in the Geneva Convention. Paech correctly observes that simply stating that a legal position is “property” will not protect an investor in the event of a higher-tier intermediary’s insolvency (as it is a matter of the substance, rather than the form, of the arrangement), although his argument that use of this term “creates unfounded expectations of certainty and safety”\textsuperscript{53} in a cross-jurisdictional context, is not entirely supported, as part four of this paper will go on to illustrate. But before that discussion can take place, it is first necessary to understand the existing EU conflicts of laws principles.

\textbf{Part Two: PRIMA}

It is clear from the discussion thus far that the crux of the debate is about the protection of the investor, as the ultimate owner of intermediated securities, from the insolvency of any of the intermediaries in the chain. Where securities are held across borders, the question arises as to which law is the applicable law for the protection of an investor’s proprietary interest. The rule that, in most, if not all private international law regimes relates to property rights in respect of tangible property is the \textit{lex rei sitae (lex situs)} rule, that is, the law to be applied is that of the place where the asset is situated. Whilst the

\textsuperscript{48} This is the approach under the English law trusts analysis and also under Art 8 of the US Uniform Commercial Code and the Geneva Securities Convention. Other systems (including the German and French systems) allow investors to claim against the issuer as well as their intermediary.

\textsuperscript{49} As was the issue in \textit{Secure Capital SA v Credit Suisse AG} [2015] EWHC 388 (Comm).


\textsuperscript{51} See, for example, E. Micheler ‘The Legal Nature of Securities: Inspirations from Comparative Law’ in L. Gullifer et al. (eds) \textit{Intermediated Securities; Legal Problems and Practical Issues} Hart Publishing (2010), p. 131.

\textsuperscript{52} Paech 2013, p. 48 (supra n. 40).

\textsuperscript{53} Paech 2013, p. 49-50 (supra n.40).
lex situs rule is entirely practical for tangible property, as it enables local enforcement of property rights to take place, it is less than helpful for intangibles. The difficulty that arises in the context of intermediated securities is that it is not clear where they are located (if, in fact, they are located anywhere).54

PRIMA is an EU conflicts of laws rule for determining rights in respect of securities and which was first developed as a response to settlement risk and introduced in the Settlement Finality Directive.55 Under the Settlement Finality Directive, the applicable law is that of the Member State in which the register, account or centralised deposit system which legally records the rights in respect of the securities, is located.56 This provision is broadly replicated in the Winding Up Directive,57 although a slightly different manifestation of the rule appears in the Financial Collateral Directive, which refers to the place where the relevant account is maintained.58 If a third party issue arises in relation to the securities, under PRIMA, the applicable law will be that of the place (Member State) of the intermediary holding the account to which the securities are credited. The practical effect is to provide a significant degree of protection for proprietary interests across the EU where accounts are held with Euroclear (Belgium) and Clearstream (Luxembourg) because both legal systems establish substantive proprietary rights for account holders.59

The difficulty with PRIMA is that, whilst its use is accepted and has in some instances been regarded as successful, it is itself flawed.60 The first reason for this is because, as directives, the Settlement Finality Directive, Winding Up Directive and the Financial Collateral Directive are implemented through national legislation. This means that there are small inconsistencies across Member States in the transposition of the directives which have been identified as a cause of legal uncertainty.61 The second flaw in PRIMA is that it is tied into the location of an account. As securities data is held electronically, it is increasingly likely that the location of an account may be found in more than one jurisdiction.62 Nevertheless, there is an argument that PRIMA is an appropriate conflict of

55 Settlement Finality Directive Arts 8 and 9(2) (supra n. 17).
56 Settlement Finality Directive Art 9(2) (supra n. 17).
57 Winding Up Directive Art 24 (supra n. 19).
58 Financial Collateral Directive Art 9 (supra n. 18).
59 Under the Belgian Royal Decree and the Luxembourg Securities Act (supra n. 21).
60 The Financial Markets Law Committee has commented that ‘the application of PRIMA has proven relatively effective within the silos where it is employed.’ See the committee’s response to the EU Consultation, available at: <www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_consultation_response_-_conflict_of_laws.pdf> accessed 31 January 2018.
61 See the European Central Bank Conflicts of Laws Issues in T2S Markets, a Fact Finding Exercise ECB 10 November 2015, 3. The EU Consultation notes that PRIMA covers slightly different assets, depending on the definition used in the directive in question at p. 9 (supra n. 10).
62 See EU Consultation, p. 9 (supra n. 10). See also the response of the Financial Markets Law Committee to the EU Consultation of 28 June 2017 which notes that relying on the situs rule will become untenable if data is stored in the cloud (supra n. 60).
laws rule as it “looks to the place of the root of title”\textsuperscript{63} and it has influenced the approach taken by the Hague Convention (as will be discussed below), albeit that the Hague Convention now requires the parties to choose the law governing the account agreement.\textsuperscript{64}

Having identified that PRIMA has imperfections, the discussion will now turn to the EU proposals which have been made to address the shortcomings of the existing conflicts of law regime in respect of intermediated securities.

Part Three: Possible solutions to EU conflicts of laws problems and problems with those solutions

The EU Consultation

The EU Consultation outlines the deficiencies of the current EU conflicts of laws arrangements with regard to intermediated securities, some of which have already been considered in parts one and two of this paper.\textsuperscript{65} For the purposes of this paper, the focus will be on the discussion flowing from Question 11 of the EU Consultation, which asks:

“Do you think that an overarching reform of conflict of laws rules on third party effects of transactions in book-entry securities is needed to provide for legal certainty?”\textsuperscript{66}

On the basis of a “yes” answer, consultees were asked to consider four options set out in Question 12 which will be the focus of critical analysis in this part of the paper.\textsuperscript{67} The four options seek to establish an “appropriate connecting factor” for establishing the applicable law and some of the options are broken down into sub-options. The first option is PRIMA, the second is the law governing the contract between the account holder and its intermediary (the account agreement), the third is the law under which the security is constituted and the fourth invites consultees to offer any other solutions they may have. Each of these options (other than the fourth) will now be considered in turn.

The options

Although PRIMA has already been discussed in some detail and its flaws already outlined, option one offers a sub-option of “Super-PRIMA”. The current understanding of PRIMA is that it should be determined for each level of the chain of intermediaries. Super-PRIMA envisages that instead, one law should be chosen to cover the whole chain of intermediaries, which would require one account to be chosen for conflict of laws purposes. It is submitted that this would be an inappropriate response to the problem as it would

\textsuperscript{63} Goode 2013, p. 253 (supra n. 15).
\textsuperscript{64} Art 4(1) of the Hague Convention (supra n. 1).
\textsuperscript{65} EU Consultation p. 8-17 (supra n. 10).
\textsuperscript{66} EU Consultation p. 15 (supra n. 10).
\textsuperscript{67} See supra n. 66.
impose the law of a particular jurisdiction throughout the entire chain of intermediaries. This would immediately create a number of problems.68 First, it would make any choice of law agreed by an account holder and their intermediary redundant, to the extent that the Super-PRIMA applicable law was different. The imposition of an applicable law throughout every link in the chain of intermediation might deter some parties from investing, even if its scope was limited to property law matters. This is because the possibility exists that the level of protection offered by the property rights in one jurisdiction may be better than that offered in another (for example, there may be different rules on priorities). The imposition of one applicable law across all intermediaries could prevent an investor from benefiting from any such advantages. Second, even though it is noted that there is almost no litigation in this area, it would nevertheless be likely to make litigation more complex if the applicable law under Super-PRIMA was not necessarily the law most naturally tied to the connecting factor in the issue.69

The second option was that of the law governing the contract, with three sub-options.70 The first of these sub-options is that the approach taken in the Hague Convention should be adopted, which raises the question as to whether the EU should simply sign the Hague Convention to bring it into EU law.71 Under this sub-option, the applicable law is chosen by the parties to the account agreement, but subject to the condition that the intermediary has a “qualifying office” in the country whose law has been chosen, with a fall back option of otherwise being determined by rules “based on the PRIMA connecting factor”.72 This approach raises two matters for consideration. The first is that there is an element of freedom of choice in deciding upon the applicable law. The second is that the choice is limited since it must demonstrate a connection between the intermediary and the choice of law in the qualifying office requirement; something that should make enforcement less difficult than if a completely unconnected jurisdiction were to be chosen. This approach may also prove more acceptable to states which currently do not allow party autonomy regarding property law. It is also similar to that taken in the US under Article 8 of the New York Uniform Commercial Code.

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68 These issues are also raised in the City of London Law Society’s Financial Law Committee (“CLLS”) in their response to Question 11 of the EU consultation dated 29 June 2017 at p. 13. The response is available at: <www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=129> (accessed 15 October 2017).
69 If, for example, the three stage process identified by Mance LJ in Raffeisen Zentral Bank Osterreich v Five Star Trading [2001] QB 825, 840 were to be applied (as it was in Secure Capital SA v Credit Suisse AG [2015] EWHC 388 (Comm)). This requires first, the characterisation of the issue; second the selection of the rule of conflict of laws laying down a connecting factor and third the identification of the system of law tied to that connecting factor.
70 EU Consultation, p. 15 (supra n. 10).
71 EU Consultation, p. 16 (supra n. 10).
72 EU Consultation, p. 15 (supra n. 10). The “fall back” rules are set out in Art 5 of the Hague Convention.
Nevertheless, despite obtaining support from a number of quarters, this approach has been criticised and much ink has been spilt in countering those criticisms. First, Article 2(1) of the Hague Convention envisages that the applicable law will determine issues including the legal nature and effects against an intermediary and third parties of credits to and dispositions from a securities account, as well as issues of priority, thus potentially affecting property rights. As Ooi contends, third parties will be disadvantaged by the fact that the account holder will choose the applicable law in its account agreement with the intermediary. This disadvantage stems from the fact that this document is not available to third parties which means that any perfection requirements for security interests in that asset would be determined by reference to the law stated in the account agreement. If perfection required registration, a problem exists for third parties in that they would not know which register to check as they would not know the applicable law.

A further criticism is that the Hague Convention would subject settlement systems to a plurality of laws which could lead to instability and ultimately systemic risk if, for example, the choice of law of the account agreement did not offer the same level of protection that exists under the Settlement Finality Directive. It is not clear that anything has significantly changed since the decision was made to withdraw the European Commission’s proposal in 2009 that would lead to the parties on either side of these discussions changing their views.

Sub-option two of the EU Consultation is that the applicable law of the contract should be chosen by the participants of the securities settlement system designated under the Settlement Finality Directive, and sub-option three is that it should be chosen by the parties to the transaction. For sub-option two, it is the law of the settlement system that becomes the connecting factor. Here, the law of one Member State (including its property laws) is imposed and (as discussed in the context of sub-option 1, above) this creates a number of problems. Equally, as Ooi points out, it is the law of the system that “has the closest and most real connection with transactions through the system” which, she argues, justifies its selection as the most appropriate choice of law for determining the proprietary effect of a transaction. Sub-option three is for the parties to the transaction, for instance between transferor and seller or transferee and buyer, to choose

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73 The Group of Thirty back in 2003 (as discussed in the Proposal at para 12 (supra n.1)) and more recently the FMLC in their response to the EU Consultation.
74 See the ECB Opinion para 11 (supra n. 2) and the criticisms set out in the Commission Staff Working Document (supra n. 3).
75 For a rebuttal of the criticisms, see Sigman and Bernasconi, 2005 (supra n. 24).
76 Hague Convention (n 1) Art 2(1)(a),(b),(d).
78 See the ECB Opinion, para 11 (supra n. 2).
79 EU Consultation, p. 15 (supra n. 10).
80 Ooi 2010, p. 232 (supra n. 77).
the applicable law, in accordance with Rome I if necessary.\textsuperscript{81} The biggest difficulty with this sub-option is that it does not provide some of the benefits that the Financial Markets Law Committee argues would be found in the implementation of the Hague Convention, including high \textit{ex ante} certainty, an internationally consistent approach and consistency between the proprietary effects of particular transactions.\textsuperscript{82} Reasons for this include the fact that not all intermediated securities are settled through a system\textsuperscript{83} and that the transactions in question may not be dispositions, but rather financial collateral arrangements.

The third option is to choose the law under which the security is constituted as the connecting factor.\textsuperscript{84} Ooi concludes that the determination of \textit{situs} by reference to, for example, securities certificates, issuer records or the jurisdiction of a company’s incorporation is unsatisfactory because it does not provide a “connecting or localising element” which identifies the investor as the owner of the securities.\textsuperscript{85} It can also be seen that it is unsatisfactory as the parties to the transaction may not fully understand the law in that jurisdiction and find to their cost that it overrides all other law.\textsuperscript{86}

\textit{Summary}

It is clear from the extensive nature of the discussions that have taken place over the years that many policymakers and academics consider that this matter is so serious that a top down approach should be taken\textsuperscript{87} whilst others consider that either no changes, or at least only minimal changes, are required.\textsuperscript{88} It is equally clear that even from those who think that action \textit{is} required, there is no consensus as to what that approach should be. There are significant difficulties with trying to find a connecting factor for intermediated securities that does not involve imposing the law of one particular jurisdiction on all the parties in the chain, and this has a corresponding impact on the determination of property rights.\textsuperscript{89} This adds weight to the argument that matters of applicable law should be addressed on the basis of the parties’ intentions as to how they wish particular matters to be addressed.\textsuperscript{90} The need for reform will now be considered in more detail, with particular

\begin{itemize}
\item \textsuperscript{81} Regulation EC/593/2008 on the law applicable to contractual obligations [2008] OJ 1777/6 (Rome I).
\item \textsuperscript{82} FMLC letter, p. 2 (\textit{supra} n. 60).
\item \textsuperscript{83} As defined in Article 2(a) of the Settlement Finality Directive (\textit{supra} n. 17).
\item \textsuperscript{84} EU Consultation, p. 15 (\textit{supra} n. 10).
\item \textsuperscript{85} Ooi 2010, p. 220 (\textit{supra} n. 77).
\item \textsuperscript{87} Paech argues for a supra-national framework by way of EU Regulation. See Paech 2013, p. 61 (\textit{supra} n. 40).
\item \textsuperscript{88} The CLLS argues only for the alignment of the definition of securities under the Financial Collateral Directive and the Settlement Finality Directive at p. 15 (\textit{supra} n. 68).
\item \textsuperscript{89} The Financial Markets Law Committee ‘Legal assessment of the arguments relating to the signing of the Hague Securities Convention – the need for, and benefits of, the Hague Securities Convention’ November 2005 discusses the difficulties of trying to determine a location based factor, see paras 3.9-3.13, available at: \url{<www.fmlc.org/uploads/2/6/5/8/26584807/58.pdf>} accessed 31 January 2018. The discussion in this paper illustrates the difficulties encountered in trying to identify a workable non-location based factor.
\item \textsuperscript{90} See the CLLS response to Question 7 (\textit{supra} n. 68).
\end{itemize}
attention being paid to the approach to reform, to determine whether looking at these problems from a different perspective may help in their resolution.

**Part Four: The approach to reform and the need for reform**

*The current debate*

The impasse that has been reached in the EU conflicts of laws debate can benefit from the application of complexity theory, a theory which recognises, as Walters observes, that "legal systems for allocating and coordinating governance authority are complex adaptive systems that evolve". The value of the application of complexity theory to the conflicts of laws debate will lie in its uses first, as a tool of deconstruction and second, as a tool in normative reconstruction, through which the problem can be viewed in a different way. Analyses thus far of the issues relating to intermediated securities have largely revolved around the fact that chains of intermediation that cross borders lead to uncertainty as to the applicable law and that this uncertainty affects the markets causing transaction costs to increase, as it is not clear which rules should be applied in the event of intermediary failure. The increase in costs is a consequence of increased levels of due diligence before transactions are completed and the issuing of complex legal opinions to address the cross-border issues that occur at each level of the chain of intermediaries. In addition to increasing transaction costs, it is considered that it also leads to opportunity costs. The desire of the EU to maximise the use of the capital markets as a driver for investment, has meant that removing the uncertainties that are associated with these costs has become imperative. The extent to which a lack of legal certainty contributes to those costs is not clear, but the evidence indicates (unsurprisingly) that there are higher costs involved in cross-border transactions than transactions conducted within country.

While considerable attention has been paid to the systems through which intermediated securities are held, limited attention has been paid to the institutions – in other words, the courts - that would have to address any conflicts of laws issues that arise in practice. Yet, as Sigman and Bernasconi indicate, the courts are the very institutions to whom any conflicts of laws rules should be addressed. Webb identifies three elements that are required for social action to occur: an understanding of the theory and workings of the system in question; an (empirical) knowledge of the institutions that both shape and are shaped by the law; and an understanding of adequate political practice and, further, holds

91 Walters 2017, p. 397 (supra n. 32).
93 Paech 2013, p. 42 (supra n. 40).
94 CMU Green Paper (supra n. 7).
95 It is beyond the scope of this paper to try and quantify these costs, but Paech’s discussion of this issue is helpful. See Paech 2013, p. 42-45 (supra n.40). See also The Giovanni Group, Second Report on EU Settlement and Clearing Arrangements (2003) generally and at p. 26.
96 Sigman and Bernasconi 2005 (supra n. 24).
that complexity theory can contribute to the first two of these.\textsuperscript{97} In this context, the social action that is required is in the resolution of a, thus far, intractable problem. Parts one to three of this paper serve to illustrate that the theory and workings of the systems through which intermediated securities are held have been explored in great detail by many eminent individuals. The focus of this part of the paper is therefore on the role of the courts as “institutions” and the extent to which they are addressing conflicts of laws issues in practice. As the failure of Lehman in 2008 was the largest failure of an intermediary to date, it makes sense to see what can be learned from the English and US litigation in that case. But first, it is necessary to explore the application of complexity theory in this context.

The application of complexity theory

Applying Webb’s analysis, the legal system of each Member State can be seen to be self-referentially closed, (that is, self-contained) albeit that when it comes to upholding proprietary interests in intermediated securities there may, in fact, be an element of normative consistency (in other words, broad agreement as to the approach) across Member States. Following Webb’s reasoning, this broadly agreed approach brings rationality to the public understanding of how intermediated securities “work”. So whilst different legal systems take different legal approaches to the problem (their individual approaches in Webb’s language being their “ad hoc” approach), at the level of practical application, they all recognise the proprietary nature of the interest of the ultimate account holder. For Webb, this general recognition (or normative consistency) glosses over what he would describe as the “ad hoc-ery” of the respective approaches taken by Member States.\textsuperscript{98} To the extent that there is no normative consistency across Member States in respect of a particular problem, conflicts will arise which will lead to short term responses within individual Member States and this lack of a broadly agreed approach can provide learning opportunities.\textsuperscript{99}

Before moving on to consider the use of complexity theory as a tool of normative reconstruction and how conflicts in the absence of normative consistency are manifest in this context, it is essential to validate the statement just made that there is an element of normative consistency across Member States that proprietary interests in intermediated securities will be upheld in their respective jurisdictions. This conclusion is derived from the European Commission’s own legal assessment of the Hague Convention in 2006, which stated:

\begin{itemize}
\item \textsuperscript{97}Webb 2005, p. 239 (\textit{supra} n. 22).
\item \textsuperscript{98}Webb 2005, p. 239 (\textit{supra} n. 22). It is not possible to explore autopoiesis in any detail in this paper but see, for example, Teubner, G. \textit{Law as an Autopoietic System} Blackwell (1993).
\item \textsuperscript{99}Webb 2005, p. 239 (\textit{supra} n. 22).
\end{itemize}
“...first, that the work of the Commission’s Legal Certainty Group has shown that no legal system in which those who hold securities through an intermediary have no property rights exists within the EU.”

Despite the confusing double negative, this is an explicit statement that all Member States recognise that those holding securities through an intermediary have proprietary rights. Further, the European Commission’s legal assessment can also be used to demonstrate the extension of normative consistency beyond the EU and into the US financial markets as the report went on to say:

“Secondly...New York law does confer property rights on those who hold securities indirectly.”

When coupled with the observation from Paech that “the current legal frameworks underpinning intermediated securities are generally relatively recent and were developed to accommodate intermediation,” this suggests that the laws of individual Member States have adapted to reflect the realities of the market place in order to achieve this observed consensus, something which is illustrative of Webb’s “ad hoc-ery”. These statements also serve to provide a high degree of ex ante certainty for investors whose assets are intermediated across these jurisdictions that their assets are safe.

Having established that there is an element of normative consistency across both the EU and the US as to proprietary rights in intermediated securities being respected, so that the interest of the ultimate account holder takes priority on insolvency, it is now necessary to consider what happens where there is no normative consistency. Webb contends that a lack of normative consistency between systems leads to conflicts and that short term responses may be generated within those systems as a consequence. In the current debate, these conflicts would be manifest as conflicts of laws; to the extent that the conflict required resolution, the parties could either settle the matter out of court or seek to go to court for a resolution. A short term, pragmatic response to the problem might be to settle the matter, whilst a longer term response through litigation would provide a case report which would lead to more clarity within that system, even though it would not necessarily produce a result that would provide more clarity for all systems, although it would provide

100 Commission Staff Working Document, p.11 (supra n. 3).
101 Commission Staff Working Document, p.11 (supra n. 3).
102 Paech 2013, p. 55 (supra n. 40).
103 See also response to the EU Consultation (supra n. 86) response No.24 (Euroclear) at para AN which suggests that uncertainty as to the applicable law is not a major issue within the EU.
104 Webb 2005, p. 239 (supra n. 22).
useful information for other courts in other jurisdictions which might learn how a particular problem might be resolved.

What the cases say

The next step is to explore the response of the courts in conflicts of laws cases to see what can be learned from them about what the correct rules in this difficult area should be, bearing in mind that the courts are institutions that both “shape and are shaped” by the law. This is important because the intensity of the debate as to what should be the appropriate conflicts of laws rules in respect of intermediated securities might lead an outside observer to think that the courts are full of cases where the uncertainties described in this paper are manifest, with judges struggling to determine which rules they should apply in a particular case and/or having to regularly apply foreign law in order to give effect to transactions that uphold the proprietary interests of the parties in question. Yet this does not appear to be borne out in practice.

An analysis of the Lehman cases that came to court in both England and the US in the period between September 2008 and April 2016 illustrates that there was little, if any, discussion as to conflicts of laws issues in respect of intermediated securities in the judgments. As noted earlier, this is not to suggest that there were no shortfall or identification issues in the litigation nor that the cross-border nature of Lehman’s arrangements was not of immediate concern in its insolvency nor that these issues were not serious ones; quite the contrary. A number of the cases illustrate the identification problems that can occur when an intermediary fails to segregate its clients’ assets as it should, so that it is not clear to whom the assets in a pool belong. Other cases illustrate how shortfalls may arise where an intermediary uses assets beneficially owned by others for its own ends in title transfer arrangements; for example, in Pearson v Lehman Brothers Finance SA, when the automated processes governing the intermediary’s repo transactions stopped, a number of title transfer arrangements remained outstanding. The reality is, however, that much of the Lehman litigation concerned the interpretation of complex financial contracts and, to the extent that it involved the allocation of property rights in

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105 Webb 2005, p. 239 (supra n. 22).
106 See Moffatt 2016 for a detailed analysis of these cases and the methodology of their selection (supra n. 25).
107 RAB Capital Plc v Lehman Brothers International (Europe) [2008] EWHC 2335 (Ch).
108 This was apparent in what became known as the “CASS Rules” cases: the Financial Services Authority issued rules as to how assets should be segregated in its Client Assets Sourcebook ("CASS") hence the CASS rules. See In the matter of Lehman Brothers International (Europe) (in administration and RAB Market Cycles (Master Fund Limited) [2009] EWHC 2545 (Ch), Re Lehman Brothers International Europe (in administration) [2009] EWHC 3228 (Ch), [2010] EWCA Civ 917 and [2012] UKSC 6.
109 Re Lehman Brothers International (Europe) (in administration); Pearson v Lehman Brothers Finance SA [2010] EWHC 2914 (Ch) [22]. RASCALS was the acronym for LBIE’s Regulation and Administration of Safe Custody and Global Settlement Working Party (see para [9] of the judgment).
respect of particular transactions, the issues were all matters of English law. None of the cases concerned a claim by parties in another jurisdiction that a proprietary issue should have been subjected to its law, rather than that of England and Wales. Although the BNY Trustee case was decided differently in England and the US, the issue was one of contractual interpretation and was not ultimately pursued in the US. The findings from the US case law are similar; there were a number of cases that touched on proprietary issues in relation to intermediated securities, but did not raise conflicts of laws issues.

So have there been any conflicts of laws case law in other contexts than the Lehman litigation? Market participants have been asked to provide concrete examples of conflict of laws issues both to the ECB, as part of the T2S Markets Fact Finding Exercise, and to the European Commission as part of the EU Consultation (which has also received contributions from a number of interested parties/individuals). It is interesting to note that there are no examples of case law in relation to conflicts of laws issues cited in the T2S study. The EU Consultation specifically asked for details of any case law relating to the definition and application of PRIMA, which resulted in a reference to Royal Bank of Scotland Plc v Hicks. Although this case does involve a conflicts of laws issue, it does not provide any guidance on the definition of, or application in practice of, PRIMA or proprietary interests in respect of intermediated securities.

Two responses to the EU Consultation referred to the first instance judgment in the Secure Capital case, heard in the High Court, which addressed issues of applicable law. In this case, Secure Capital (the investor) wanted to sue the issuer of eight notes issued in bearer form and held by an intermediary through Clearstream. Each note was represented by a single permanent global security held by Bank of New York Mellon (“BNYM”). The claim was for breach of contract for allegedly breaching the no misleading statements term of the note. Secure Capital claimed that it was entitled to rely on a provision of Luxembourg law that it could exercise the rights of a bearer noteholder in bringing a breach of contract claim against the issuer, even though it was not itself the bearer of the notes. Credit Suisse, as issuer of the notes, claimed that there was no contractual relationship between

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110 Belmont Park Investments PTY Limited (supra n. 25).
111 See Moffatt 2016 (supra n. 25).
112 See T2S Study (supra n. 26).
113 EU Consultation Question 3 (supra n. 10).
114 T2S Study p. 54-57 (supra n. 26).
115 EU Consultation Question 6(a) (supra n. 10).
117 Secure Capital SA v Credit Suisse AG [2015] EWHC 388. This was referred to by respondents No. 17 (the CLLS) and No. 29 (Benjamin, J.) in the responses to the EU Consultation (supra n. 68). This case has since been heard in the Court of Appeal, [2017] EWCA Civ 1468.
118 See [2017] EWCA Civ 1468 [5].
it and Secure Capital as the notes were held through an intermediary. At first instance, the court held that this was a matter that should correctly be characterised as contractual and therefore the applicable law was, in this case, English law; Luxembourg law was irrelevant. Under the terms of the notes, only BNYM had directly enforceable contractual rights against the issuer in the absence of a default in the payment of principal (which had not occurred). As is typical in such transactions, account holders (and through them, noteholders as the ultimate investor) would only acquire direct rights against the issuer in the event of a non-payment of principal by the issuer. This decision (which illustrates the “no look through” principle) was unanimously upheld by the Court of Appeal.  

Both these cases add weight to the argument that there is little or no case law relating to conflicts of laws issues in respect of proprietary issues arising in the context of intermediated securities. Perhaps surprisingly, none of the respondents to the EU Consultation referred to the Kolassa case, in which the CJEU had to consider the question of jurisdiction in a tort case where the issue concerned a securities account. This case has been criticised (correctly, in the author’s view) by Haentjens and Verhei who consider that the CJEU “failed to properly understand the law and practice of the issue and custody of securities”, so the judgment does little to advance the discussion of conflicts of laws in this context. The T2S study recognised a “paucity of concrete cases” but attributed this to the fact that legal uncertainties discourage the completion of cross-border trades, rather than “a genuine lack of issues” that would benefit from legislative or other “top-down intervention”. But this conclusion does not align with the findings from the Lehman litigation, where trades had been completed and were, as Moss describes it, “broken in the middle”. 

It would be simplistic to say that there are no conflicts of laws issues that arise in the context of intermediated securities held through a chain of intermediaries – all the work that has been done over the last fifteen to twenty years and discussed in this paper suggests otherwise. The fact is, however, that these problems have not been manifest in the courts. In the Lehman litigation, much was resolved through the Lehman Protocol and settlement agreements that were undisclosed to the public; it is not a matter of public

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119 [2017] EWCA Civ 1468. For a discussion of the basis for the decision, see supra n. 69. The terms of the notes had deliberately excluded the rights of third parties to bring a claim under the Contracts (Rights of Third Parties) Act 1999. As the Court of Appeal noted, it was surprising that the investor had not sued in tort as such a claim would not have been barred. 

120 Case C-375/13 Harald Kolassa v Barclays Bank Plc. 


122 T2S Study p. 3 (supra n. 26). 


record as to whether any investors, as ultimate account holders, suffered a shortfall.\textsuperscript{125} What is a matter of public record is that those with proprietary interests were paid in full, which suggests that their proprietary interests were upheld.\textsuperscript{126} It is also clear, as has already been discussed, that there is broad consensus across both the EU and the US as to the recognition of the rights of investors in securities held through intermediaries; there is therefore no need to litigate on the interpretation of a flawed conflicts of laws rule. What was a real concern in the Lehman case was the amount of time that it took to pay creditors, with payments still being made a decade later.

Reframing the debate

If the main concern is that the conflicts of laws rules are uncertain, this does not appear to be made out in the cases. With the exception of the Kolassa case, there is little in the case law to suggest that the courts do not know how to address questions of conflicts of laws. In Secure Capital, the matter was apparently completely straightforward with four judges (one at first instance and three in the Court of Appeal) all taking a unanimous view as to the applicable law. The professionalism of those working through the Lehman litigation also illustrates that, despite the volume of work entailed, the courts could find solutions to complex problems, Briggs J noting that the courts acted as arbiters as to the legal effect of transactions by applying “the law chosen by the parties to govern the transactions in question”.\textsuperscript{127} Recent work done by Walters’ illustrates that “critics overemphasise formal jurisdictional rules and pay insufficient attention to how courts actually exercise jurisdiction in practice”\textsuperscript{128} which serves to reinforce the point that the courts do actually know what their job is and how to reach workable, sensible solutions.

This part of the paper has sought to deconstruct the conflicts of laws problem as it is currently defined. It is now necessary to reconstruct the debate setting out a new normative approach in part five.

Part Five: Conclusion

A normative reconstruction?

As this paper has illustrated in parts one to three, the received opinion as to the best way to overcome the uncertainties that arise from holding intermediated securities is to re-

\textsuperscript{125} Statement regarding approval of LBI Agreements with LBIE and LBHI 16 April 2013, <dm.epig11.com/LBI/Project> accessed 26 October 2017.
\textsuperscript{126} <www.pwc.co.uk/services/business-recovery/administrations/lehman/update-entitlements-to-surplus-28-march-2014.html> accessed 29 October 2017 illustrates that no further payments above 100p would be paid until the unsecured creditors claims had been resolved.
\textsuperscript{128} Walters (supra n. 32).
write the conflicts of laws rules so that everyone is clear what they are. A lack of clarity, it is argued, is holding up business. By extension, a lack of clarity might also be presumed to be leading to lots of cases in the courts and difficulties for courts in deciding those cases. Yet part four of this paper has suggested that there is not a glut of cases in this area, nor that the courts are struggling to resolve them. This observation could legitimately lead to normative reconstruction of the debate to the effect that there is not a “real world” conflicts of laws problem (it is a theoretical one), thus enabling the question to be asked as to whether the issues that concern academics and policy makers are actually conflicts of laws issues at all?

The market is worried that an intermediary might fail causing havoc in the world of intermediated securities; the key disasters being an inability to identify assets and shortfalls in those assets. In the Lehman case, the complexity of identifying client assets led to delays in paying investors; but this was not manifest in the courts as a conflicts of laws issue. Identification problems were caused by Lehman failing to allocate assets to accounts correctly, which meant that every transaction had to be unravelled in order to work out whose assets were whose. It is difficult to see how this problem could be approached differently in a future similar case, even with a global conflicts of laws regime in place. Similarly, shortfalls that may have arisen so depriving investors of their assets, were the result of intermediaries re-using financial collateral. Whilst rehypothecation is accepted as being essential to the smooth functioning of the financial markets, it can cause problems where an intermediary is “out of the money” at the point of its insolvency. A failure by the intermediary in such a case to retain sufficient collateral in respect of logged obligations can leave the ultimate account holder with a shortfall. This is less a conflicts of law matter than a regulatory issue for the market place as to whether this is an acceptable practice bearing in mind the potential consequences for investors in the event of the intermediary’s insolvency.129

Support for this normative reconstruction can be found in an examination of the responses to the EU Consultation. It is significant that 21 out of 31 respondents on record do not consider that there are any major difficulties "encountered because of dispersal of conflicts of laws rules in EU directives and national laws”.130 Of those respondents which considered that difficulties did exist, reasons included discrepancies in coverage of the existing conflicts of laws rules in the Settlement Finality Directive, Financial Collateral Directive and

129 Art 24 of the Geneva Convention addresses this issue by requiring matched funding to ensure that all logged obligations are met by lodged collateral. See also the Securities Financing Transaction Regulation (EU) 2015/2365 OJ [2015] L337/1; there are now enhanced disclosure requirements where collateral is reused.

130 See responses to the EU Consultation responses to Question 7 (supra n. 86).
Winding Up Directive and increased costs with only a few respondents suggesting that the difficulties were “potentially very significant”.  

From the perspective of the EU, this analysis suggests that it makes sense to rectify the discrepancies between the Settlement Finality Directive, Financial Collateral Directive and Winding Up Directive and their implementation by individual Member States; it is not clear that it is necessary to do much more. Bearing in mind that there is a consensus across the EU and US that investors have a proprietary interest in intermediated securities (something which only really matters on the insolvency of an intermediary in any event), it must make little real difference to the EU whether it signs the Hague Convention or not, except to the extent that third countries beyond the US might do so at some point in the future. The opportunity costs caused by legal uncertainties are unclear, but presumably market players note the limited evidence of significant difficulties in practice and are broadly satisfied their interests will be protected and factor this into their pricing and their market activity in any event.

The movement to preserve the functions of a failing financial institution rather than its form in an effort to overcome the problem of too big to fail is now encapsulated within the EU in the Bank Recovery and Resolution Directive and the Single Resolution Regime. The new regulatory regime has been designed so that the failure of an intermediary such as Lehman would not happen in the same way again. Intermediaries would, presumably, be bailed in or subject to resolution so that their functions would continue, so avoiding the breaking of transactions in the middle that caused so many identification issues in the Lehman case. All this indicates that it would make more sense for the EU to focus on the other matters that would make financial markets operate more smoothly, such as ensuring that the rules for the allocation (and thus identification) of assets in client accounts are followed accurately in practice.

Looking at the wider, global issues in relation to intermediated securities, the concerns lie beyond the EU and the US. As Judge Peck remarked, “economic actors ... will choose to co-operate across borders only where it serves their goals to do so.” Both the courts of the EU Member States and the US Bankruptcy Court have significant experience of cross-border cooperation. That the courts work intelligently and pragmatically in cross-border cases to achieve sensible outcomes is evident from Walters’ paper. What will

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131 See supra n. 86.
132 As discussed in part four.
133 As discussed in part four.
136 Walters 2017 (supra n. 32).
happen in the courts of third countries beyond the US is less clear. It may ultimately boil down to how seriously such countries wish to be taken in the market place as to whether they will join the consensus that proprietary interests in intermediated securities should be protected wherever they happen to be within the chain of intermediaries; a failure to honour commitments may result in a loss of business as investors actively avoid those jurisdictions to the financial disadvantage of those jurisdictions.

From the perspective of the UK, it is hard to see that signing the Hague Convention is a priority for the UK government in the light of Brexit. It brings no obvious advantages (unless third countries beyond the US sign up) and has the disadvantage of affecting proprietary interests. The approach of the courts in upholding the parties’ intentions worked in Lehman\(^{137}\) and provides evidence to the rest of the world that the UK has clear and understandable laws, which may be the best message it can currently send out.

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\(^{137}\) Briggs 2012 (*supra* n. 126).