EUROPEAN
COMMISSION

Brussels, 12.3.2018
COM(2018) 89 final

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

on the applicable law to the proprietary effects of transactions in securities

{SWD(2018) 52} - {SWD(2018) 53}

1. INTRODUCTION

The Commission's priority is to further strengthen Europe's economy and stimulate investment to create jobs and sustain growth. In order to reach this objective, there is a need for stronger, deeper and more integrated capital markets. Efficient and safe post-trade infrastructures are key elements of such well-functioning capital markets. Following on from the Action Plan on Capital Markets Union (CMU)[1], in June 2017 the Commission's Mid-term Review[2] set out the remaining actions which will be taken to put in place the building blocks of CMU by 2019, with the objective of removing barriers to cross-border investment and lowering the costs of funding. Completing the CMU is an urgent priority.

As part of the CMU Action Plan and the Mid Term Review, the Commission announced targeted action to reduce legal uncertainty on cross-border transactions of securities and claims. This Communication and the legislative proposal on the applicable law to the proprietary effects of assignment of claims, also presented today, implement this commitment.

The purchase and sale of securities, as well as their use as collateral, take place daily across the EU in large volumes. A significant part of these transactions, amounting to around EUR 10 trillion per year, involve a cross-border element.[3]

In order to promote cross-border transactions, clarity and predictability about which country's law applies to determine who owns the underlying assets of the transaction is of the essence. If there is legal uncertainty over who owns the asset, depending on which Member State's courts or authorities assess a dispute concerning the ownership of a claim or a security, the cross-border transaction may be enforceable or not, or might confer the expected legal title on the parties or not. In case of insolvency, when the questions of ownership and enforceability of transactions are put under judicial scrutiny, legal risks stemming from legal uncertainty may result in unexpected losses. The objective of this Communication is to help increase cross-border transactions in securities by providing legal certainty on the conflict of laws rules at Union level. Enhanced legal certainty will promote cross-border investment, access to cheaper credit and market integration.

On securities, three directives address the question which national law applies in case of cross-border transactions: the Financial Collateral Directive[4], the Settlement Finality Directive[5] and the Winding-up Directive[6]. These directives include conflict of laws rules that cover the most important aspects of securities transactions. However, their wording gives rise to different national interpretations. The lack of clarity created by different interpretations of

[1] Communication on 'Action Plan on Building a Capital Markets Union' ('CMU Action Plan'), COM(2015) 468 final.
[2] Communication on ' on the Mid-Term Review of the Capital Markets Union Action Plan', COM(2017) 292 final.
[3] ECB data suggests that the estimated volume of cross-border investments, by residence of the investor, stood at EUR 10.6 trillion in 2016. Source: ECB securities settlement statistics (28.6.2017).
[4] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements ('Financial Collateral Directive') OJ L 168, 27/06/2002.
[5] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ('Settlement Finality Directive') OJ L 166/45, 11/6/1998.
[6] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions ('Winding-up Directive) OJ L 125 , 05/05/2001.

the existing rules might make cross-border transactions more costly due to some residual legal uncertainty around which law is applicable.

Given the volume of transactions concerned, the Commission is of the view that a clarification of the rules is necessary to help markets reduce redundant costs and increase legal certainty around the applicable law.

This Communication clarifies the Commission's views on important aspects of the existing EU acquis with regard to the law applicable to proprietary effects of transactions in securities.

This Communication covers the third-party effects of the transfer of financial instruments. It accompanies the legislative proposal on third-party effects of assignment of claims[7]. Matters governed by the Financial Collateral Directive, the Settlement Finality Directive, the Winding-up Directive and the Registry Regulation[8] are not, however, affected by that legislative proposal[9].

2. WHAT DOES THE EU ACQUIS SAY?

Cross-border transactions in securities are important building blocks of the Capital Market Union. As national securities laws are not harmonised at the EU level, conflict of laws rules determine which national law applies for cross-border transactions.

Two elements of transactions in securities are governed by conflict of laws rules: (i) the proprietary element, which refers to the transfer of rights in property and which affects third parties and (ii) the contractual element, which refers to the parties' obligations towards each other under the transaction.[10] While the contractual element is already regulated at EU level by the Rome I Regulation,[11] this Communication concerns the first aspect, proprietary effects of securities transactions. In practice transacting parties need to rely on these rules concerning proprietary effects in case of an insolvency, where they need to recover assets.

The current EU *acquis* includes provisions to determine in specific cases which national law applies to proprietary effects of cross-border transactions in securities. These are set out in three Directives: the Settlement Finality Directive, the Winding-up Directive and the Financial Collateral Directive.

Article 9(2) of the Settlement Finality Directive, adopted in 1998, contains the following conflict of laws provision:

[7] Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims COM(2018) 96.

[8] Commission Regulation (EU) No 389/2013 of 2 May 2013 establishing a Union Registry pursuant to Directive 2003/87/EC of the European Parliament and of the Council, Decisions No 280/2004/EC and No 406/2009/EC of the European Parliament and of the Council and repealing Commission Regulations (EU) No 920/2010 and No 1193/2011.

[9] See Article 9(1) and (2) of the Financial Collateral Directive, Article 9(2) of the Settlement Finality Directive and Article 24 of the Winding-Up Directive, which refer to book-entry securities (FCD and SFD) or (financial) instruments recorded in a register or account (WUD).

[10] The contractual elements include for example the offer, its acceptance, consideration, certainty of terms of the contract, etc. and are subject to the conflict of laws rules of the Rome I Regulation. Regulation (EC) 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I): http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32008R0593&from=EN

[11] Regulation (EC) 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I).

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 the 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.

The Winding-up Directive, adopted in 2001, contains the following conflict of laws rule in Article 24:

The enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralised deposit system held or located in a Member State shall be governed by the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located.

Finally, the Financial Collateral Directive, adopted in 2002, formulates its conflict of laws provision in Article 9 (1) and (2) in the following manner:

1. Any question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country.

2. The matters referred to in paragraph 1 are:
(a) the legal nature and proprietary effects of book entry securities collateral;
(b) the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and the provision of book entry securities collateral under such an arrangement, and more generally the completion of the steps necessary to render such an arrangement and provision effective against third parties;
(c) whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest, or a good faith acquisition has occurred;
(d) the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

Since the application of Directive 2014/65/EU on 3 January 2018 (MiFID II), emission allowances listed as financial instruments in point (11) of Section C of Annex I of the Directive have come within the scope of the Settlement Finality Directive and the Winding-up Directive and their provisions on conflict of laws. Notwithstanding this, the Communication does not take into account the specificities of such emission allowances, notably with regard to their being held in accounts located in the Union Registry governed by a specific conflict of law provision in Regulation (EU) No 389/2013 adopted under Directive 2003/87/EC[12].

[12] Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC.

The conflict of laws provisions in the Settlement Finality Directive, Financial Collateral Directive and Winding-up Directive designate the applicable law based on a common approach. They are similar in that they all designate an applicable law based on the place of the relevant register or account (and in the case of the Settlement Finality Directive and the Winding-up Directive, the centralised deposit system). Nevertheless, the provisions differ in detail and there appear to be some differences in how they are interpreted and applied across Member States. In particular, this concerns the definition and determination of where the account is 'located' or 'maintained'.

3. IMPROVING CLARITY IN THE EXISTING EU ACQUIS

3.1. Do the terms 'maintained' and 'located' mean different things?

The Commission is of the view that the difference in wording, referring to the place of the account or register, does not imply any difference in substance.

The Settlement Finality Directive, Financial Collateral Directive and Winding-up Directive define the applicable law by reference to the *place of the relevant account*. In accordance with Article 9(2) of the Settlement Finality Directive and Article 24 of the Winding-up Directive, the applicable law is the law where the account or register is 'located', while the Financial Collateral Directive refers in Article 9(1) to the law in which the relevant account is 'maintained'. None of the Directives however specify whether 'located' means the same as 'maintained'.

The Commission is of the view that ‘located’ means the same as ‘maintained’ for the following reasons.

First, Recital (7) of the Financial Collateral Directive explains that the objective of the conflict of laws provision is to extend the principle already set out in the Settlement Finality Directive[13].

Second, as previously highlighted in the 2007 Commission Working Document, the difference in wording between the Financial Collateral Directive and the Settlement Finality Directive reflects recognition – when adopting the Financial Collateral Directive – that EU securities markets had evolved in ways that allowed for a more suitable expression, i.e. the place where the account is maintained – to be used to describe the same formula[14].

Third, the differences in terminology are not present in all linguistic versions of the Directive. While the English versions of the Settlement Finality Directive and Winding-up Directive use the terms 'located' and the Financial Collateral Directive uses that of 'maintained', several language versions of the Settlement Finality Directive and the Financial Collateral Directive refer to the exact same term, e.g. the French, Italian and Romanian versions of the Settlement Finality Directive and Financial Collateral Directive include the same reference to where the relevant account is 'located' (situé - situato - se află). In other linguistic versions, other terms are used, such as the Portuguese language version that makes a differentiation between 'located' and 'situated' and the Dutch version referring to 'located' and 'held'.

[13] The principle in Directive 98/26/EC whereby the law applicable to book entry securities provided as collateral is the law of the jurisdiction where the relevant register, account or centralised deposit system is located, should be extended in order to create legal certainty.

[14] Commission staff working document 'Legal assessment of certain aspects of the Hague Securities Convention', p. 8, SEC(2006) 910.

3.2. Determining where the account or register is 'located' or 'maintained'

The Commission observes that under national implementation there are different ways to determine where a securities account is 'located' or 'maintained'. Without prejudice to potential future decisions of the Court of Justice of the European Union, these different ways of interpretation all appear to be valid under the Directives. The conflict of laws provisions in the three Directives do not provide clear definitions of how to determine where the securities account is located or maintained. However Recital (8) of the Financial Collateral Directive states clearly the common basis for conflict of laws across the EU:

> *The lex rei sitae rule, according to which the applicable law for determining whether a financial collateral arrangement is properly perfected and therefore good against third parties is the law of the country where the financial collateral is located, is currently recognised by all Member States.*

Further sources are not available to clarify how maintenance and location should be determined, as other EU acts do not provide such definition, and so far there is no case law from the Court of Justice of the European Union on how these concepts should be interpreted.

The Commission observes that many Member States, when transposing the provisions of the Settlement Finality Directive and the Winding-up Directive, have not included any additional criteria in their national legislation that would prescribe how to determine the jurisdiction where the account or register is 'located'. [15] Similarly, many national transpositions of the Financial Collateral Directive do not add any clarifications at national level as to how to determine where the account is 'maintained'. [16]

In those cases where national laws do provide additional guidance, approaches may differ in their result. Also, in those Member States where no clarification was added in the national transposition, case law or academic literature might provide elements that help apply the concepts of the location or maintenance of the account in practice. These non-codified elements might also lead to diverging results.[17]

There are a number of Member States that currently interpret and apply the conflict of laws provisions of the Financial Collateral Directive in a way that they look at the place where the custody services are provided. Others look at the account agreement for information about the place where the account is maintained. The latter solution might offer the convenience of potentially avoiding different applicable laws internationally, in transactions involving jurisdictions that apply a choice of law solution. Another approach that avoids different laws applicable to an international transaction in a narrower set of cases (where a third-country choice of law clause opts for the law of a Member State), is when 'maintained' is determined in a way that it allows the choice of that Member State's law to be valid under the Hague Securities Convention[18]. This is the case when 'maintained' is defined as *effecting or monitoring entries to securities accounts, administering payments or corporate actions, or*

[15] At least 16 Member States have not added further clarifications in their national provisions implementing the relevant provisions of the SFD and the WUD. Source: Evaluation in Annex 5 to the Impact Assessment SWD(2018)52, pp 116-117.

[16] At least 13 Member States have not added further clarifications in their national provisions implementing the relevant provision of the FCD. Source: Evaluation, pp 117-118.

[17] For example there are different approaches under the FCD to determine where the account is maintained. Source: Evaluation, pp 117-118.

[18] Convention on the law applicable to certain rights in respect of securities held with an intermediary, available at: https://assets.hcch.net/docs/3afb8418-7eb7-4a0c-af85-c4f35995bb8a.pdf

performing any other regular activity necessary for the administration of securities accounts. Without prejudice to any future decisions of the Court of Justice of the European Union, all of the above solutions appear to be valid under the relevant EU provisions.

4. CONCLUSION

This Communication provides a proportionate response to the residual legal uncertainty of existing EU conflict of laws rules in the field of proprietary effects of securities transactions. A clarification of the Commission's views should shed light on existing solutions as to how the relevant provisions of the Settlement Finality Directive, Financial Collateral Directive and Winding-up Directive are applied at present, leaving freedom to the Commission to assess in the future – in light of international, technological or market developments – whether further action may be necessary. In this respect, it should be underlined that this Communication is without prejudice to the interpretation that the Court of Justice of the European Union may give of the aforementioned issues in the future. The Court remains responsible in the final instance for interpreting the Treaty and secondary legislation, or by future Commission action, in particular of a legislative nature. This Communication is also without prejudice to future Commission action taken in accordance with Directive 2003/87/EC with regard to greenhouse gas emission trading allowances.

National authorities and administrations should take into consideration the clarifications provided in this Communication when applying the conflict of laws provisions of the Settlement Finality Directive, the Financial Collateral Directive and the Winding-up Directive. Member States should continue to observe if any legal discrepancies occur at the level of national interpretations that might cause market disruptions, and aim to converge in their interpretation and application of the existing EU rules.

The Commission will continue to monitor developments in this area and in consultation with stakeholders assess how national interpretations and market practices evolve, in light of international and technological developments. Evidence from stakeholders on the impact of specific issues on the functioning of the internal market will be particularly assessed. Any possible future legislative initiative will be accompanied by an impact assessment.