Feature

KEY POINTS

- Consultation responses suggest that attempts at overarching reform may involve substantial upheaval in the markets of many Member States.
- Conflict of laws rules in this area, particularly in relation to book-entry securities held by intermediaries, are complicated and diverse.
- Responses to the Consultation, published so far, have indicated mixed support for the project.

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Should the EU address conflict of laws questions thrown up by cross-border capital markets?

Rory Cochrane considers the magnitude of the task set by the European Commission in its recently concluded consultation "on conflict of laws rules for third party effects of transactions in securities and claims".

INTRODUCTION

The European Commission has recently concluded a consultation "on conflict of laws rules for third party effects of transactions in securities and claims" (the Consultation). That relatively technical title might be said to obscure the importance of the topic to the casual reader, and the magnitude of the task the Commission has set itself. The Consultation in fact concerns what, if anything, the EU can and should do in order to address conflict of laws questions thrown up by cross-border capital markets (which in this context essentially means investment activity in securities, and the assignment and trading of claims, including receivables). The enquiry is therefore a very broad one that encompasses a large number of profoundly difficult questions.

BACKGROUND

The Consultation forms part of the Commission's Investment Plan for Europe, which includes the core component of establishing a Capital Markets Union (CMU) in Europe. The benefits of facilitating the free flow of capital are potentially significant. In the Commission's "Action Plan on Building a Capital Markets Union" (CMU Action Plan), the Commission noted that if European venture capital markets were as deep as those in the US, then more than €90bn in funds would have been available to finance companies between 2009 and 2014 (CMU Action Plan, page 4). If the EU securitisation market could be restored to the level it attained before the financial crisis of 2007/08 (safely, it is emphasised), then banks would be able to lend an additional €100bn to the private sector.

However, the scope and complexity of the project renders it potentially one of the most complicated multilateral law reform projects attempted. First, the "securities" at issue include almost all forms of tangible and intangible security traded on capital markets. Sensibly, no attempt has been made at particularising each individual species of asset, nor the many ways in which they may be structured or held. Instead, the Consultation describes essentially three broad categories of asset:

- Book-entry securities. These assets are the things most will think of when using the word "securities" in the modern day, and represent the vast majority of traded financial instruments in capital markets, and include shares and bonds that are acquired and disposed of by credits and debits in the accounts of intermediaries;
- Certificated securities. At the simplest level, these are securities held physically by an investor (bearer securities). These are perhaps increasingly rare, although remain important in particular in small to medium loan transactions where lenders require security in the shares of the borrower and related companies. The Law Society of England responded to the Consultation on the basis that the term "certificated securities" included '*dematerialised securities held in direct-holding systems such as CREST, as well as bearer securities*'. That quite broad interpretation of the Consultation's definition appears correct, but it is not obvious on the face of the Consultation, which may have impacted on the responses the Commission received; and
- Claims: defined widely for the Consultation and includes any right to payment of a sum of money (eg receivables) or to performance of an obligation irrespective of whether it is contractual or non-contractual. Reform in this area would be of significant importance in the factoring and invoice financing, asset financing and receivables industry.

Second, the diversity of approaches of Member States to these questions means that any attempt to impose uniformity will involve substantial upheaval in many Member State markets. It is probably for that reason that an attempt in the context of the Rome I Regulation to include provisions regulating the third party effects of assignment of claims failed.

It is, therefore, a daunting undertaking. The Commission received 49 responses to the Consultation from banks, government agencies, industry associations and other market participants. Those responses, it is fair to say, have generally been mixed, with some citing concerns about the difficulties involved and the need for stability and continuity. The French Association of Securities Professionals (the AFTI), for example, states that despite ongoing debate since 2000 about conflict of laws issues in securities and capital markets, *'the markets have been functioning very well over the last 17 years; hardly any case law exists and the markets have recently (June 2015) responded to the ECB's T2S Steering Committee that there is no need to revise the existing conflict of law rules'*. The City of London Law Society submission equates overarching reform of conflict of rules on third-party effects of transactions in book-entry securities to opening a "Pandora's box".

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CONFLICT OF LAWS IN SECURITIES

It is easy to provide a few examples to illustrate how conflict of laws problems, particularly in relation to choice of law or applicable law issues, can arise in this context. A thorough consideration of some of the difficult scenarios is set out in the only work of any real length on the topic, *Shares and Other Securities in the Conflict of Laws* by Maisie Ooi (Oxford University Press, 2003).

Take the example of a simple sale of a share in a company by a vendor in one state to a purchaser in a second state. If the purchaser alleges that he was missold the share in breach of contract, which substantive law is to apply to the transaction? Might the result differ in tort and contract? Generally, the Rome I Regulation would provide the answer for a court in a Member State to questions relating to contractual disputes, no matter where the contract was formed. However, the position under Rome I with respect to the proprietary consequences of these transactions is less clear, with academics having argued both for and against Rome I applying.

The problem of the proprietary consequences of securities transactions is a striking one. For example, what is the applicable law if the original purchaser on-sells the share to a third party in a third state, and the original vendor alleges that property in the share did not pass to the second party due to an absence of some necessary formality in the first state, or due to the fraud of the original purchaser? This is a concern not only for the immediate recipients of securities, but also for parties down the line of subsequent transactions. In the particular example of uncertificated shares held through a third party intermediary (so-called "dematerialised" shares), the Rome I Regulation does not appear to provide a clear answer (see Dicey, Morris & Collins, *The Conflict of Laws*, at §24-071). Attempts have been made at dealing with the problem – in particular, the Hague Conference on Private International Law developed the "Convention on the law applicable to certain rights in respect of securities held with an intermediary". However, that convention has been criticised (see Dicey, Morris & Collins, at §24-073), and has not been adopted in Europe.

The Commission states that if a transaction takes place domestically, there is usually no problem in answering these questions *'based on national substantive law'*. However, anyone familiar with the English law relating to the proprietary aspects of intangible property will know that it is itself rarely straightforward (see the BIICL, "Study on the question of effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over a right of another person", 2011, 343–346). Whether a person ought to be entitled to a proprietary, or merely personal interest in cases involving misappropriated property, for example, is the subject of intense academic and judicial debate. It may be that effective European reform in this area should start with the harmonisation and rationalisation of the substantive law, rather than the conflict of laws rules. Given the divergent and fundamental approaches to these questions in different jurisdictions, that seems unlikely to occur.

A further complexity arises if the third party (or indeed a fourth, or fifth party) then becomes insolvent. As the Consultation points out, these are questions that are not directly governed by the Insolvency Regulation Recast or the Winding-up Directive. While article 10 of the Winding Up Directive states that a credit institution shall be wound up in accordance with the laws, regulations and procedures applicable in its home Member State, it does not provide the answer to all proprietary issues that may arise in respect of property not situated in the home Member State of the institution.

The Commission also raises the spectre of institutional risks being exacerbated by "domino" effects where a conflict of laws issue arises which affects a large number of industry participants at once. It may well be that the Commission has in mind the events of 2008, and in particular the collapse of Lehman Brothers. However, as a number of responses to the Consultation point out, significant conflict of laws difficulties in fact never arose in the Lehman administration (see the Response of the City of London Law Society). This was probably because of the need to get claims settled without recourse to long-running litigation in what was already an enormous and complicated insolvency. However, the view is also offered that the conflict of laws rules as between the different states in which Lehman assets were located were not so different as to be problematic. That would tend to suggest (if it is correct) that significant EU law reform in this area may be unwarranted. Nevertheless, the Commission appears to believe that there are considerable legal risks for market participants in this area, and that addressing these issues may assist in freeing up capital markets.

WHITHER JURISDICTION ISSUES?

Despite the ambitious scope of the project, one is left with the sense that the Consultation fails to engage with a very significant aspect of the conflict of laws as it relates to securities: that of jurisdiction issues. The focus is plainly on choice of law/applicable law considerations. The Commission does allude briefly to a risk of forum shopping, but in doing so appears to confuse the choice of law/applicable law issues with the question of which Member State's courts have jurisdiction. If forum shopping is a concern that may undermine the certainty and integrity of CMU, it is surprising that the Commission has not sought views on the current state of the law, including cases such as *Kolassa v Barclays Bank plc* [2015] EUECJ C-375/13, in which the Court of Justice of the European Union ruled on jurisdiction issues under the Brussels Regulation. However, that may be an issue upon which the Commission intends to seek expert input further down the track.

CONCLUSION

The Consultation cannot be faulted for want of ambition. However, real questions have been raised about whether this is ultimately an area that can be improved by overarching reform, as opposed to targeted amendment of existing EU legislation. There appears to be a desire in some quarters of the market to privilege stability and continuity over legal coherence. In an area that has been affected by so much legislative reform in the past decade, this is perhaps understandable. Finally, it is important (perhaps inevitable) to note that these reforms, if implemented, will remain relevant for lawyers in Britain no matter the outcome of Brexit. Any harmonised European conflict of laws rules will apply in certain circumstances to non-EU states, including the United Kingdom, if those states invest in European capital markets and (necessarily) litigate in European courts. ■