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**COMMISSION STAFF WORKING DOCUMENT**

**IMPACT ASSESSMENT**

*Accompanying the document*

**Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**on the law applicable to the third-party effects of the assignment of claims**

**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**

{COM(2018) 96 final} - {COM(2018) 89 final} - {SWD(2018) 53 final}

## TABLE OF CONTENTS

Table of Contents .....	1
1 Introduction: political, market and legal context .....	4
1.1 Political context .....	4
1.2 Market context: significant markets for claims and securities but large variations in the cross-border dimension of transactions .....	5
1.2.1 Transactions and assets concerned .....	5
1.2.2 Factoring, which relies on claims, is an important source of financing for firms in the real economy .....	6
1.2.3 Significant markets in collateralisation and securitisation, both relying on claims and securities, allow better access to finance for firms and consumers .....	7
1.2.4 Transactions in securities are sizeable, with an important cross-border dimension .....	10
1.3 Legal context: no EU rules on claims, three EU directives on securities .....	11
1.3.1 Conflict of laws rules relating to the assignment of claims .....	12
1.3.2 Conflict of laws rules relating to securities transactions .....	15
1.4 International context: The Hague Securities Convention and the UN Convention on the Assignment of Receivables in International Trade .....	15
1.4.1 The Hague Securities Convention and past attempt to ratify it .....	16
1.4.2 UN Convention on the Assignment of Receivables in International Trade .....	17
2 The problem drivers: rules designating the applicable law are inconsistent .....	17
2.1 National conflict of laws rules on the third-party effects of assignments of claims are divergent and unclear, leading to legal uncertainty .....	17
2.2 EU conflict of laws rules relating to securities are interpreted differently across Member States .....	20
2.3 Scope and methodology .....	21
2.3.1 Which legal issues are unclear? .....	21
2.3.2 Transactions and assets concerned .....	22
2.3.3 Methodology and access to data .....	23
3 The problem: cross-border transactions are inherently riskier than domestic ones .....	24
3.1 The legal risk in cross-border transactions leads to potential losses (with stability risks), higher costs and reduced market integration .....	24
3.2 Proprietary effects of assignments of claims: absence of EU conflict of laws rules and inconsistent national conflict of laws solutions .....	26
3.3 Proprietary effects of transactions in securities: residual legal uncertainty .....	27
3.4 Ignoring the risks can lead to losses .....	28

3.4.1	Important risks relating to the assignment of claims.....	28
3.4.2	Theoretical risks of losses with no material evidence for transactions in securities.....	29
3.5	Mitigating risks means higher costs for cross-border transactions.....	29
3.5.1	The significant cost of cross-border assignments of claims.....	29
3.5.2	Residual legal risk relating to transaction in securities.....	30
3.6	Avoiding the legal risk leads to less cross-border activity.....	31
3.7	Various market participants are affected negatively.....	32
3.7.1	Companies, including SMEs.....	32
3.7.2	Factoring and securitisation industry.....	32
3.8	How would the problem evolve, all things being equal?.....	33
4	Why should the EU act? Legal basis, subsidiarity and added value.....	33
5	What should be achieved?.....	35
5.1	The policy objectives.....	35
5.2	Consistency with other EU policies and the Charter for fundamental rights.....	36
6	Claims: options, impacts and who will be affected.....	37
6.1	Baseline: no EU intervention.....	37
6.2	Harmonising conflict of laws rules.....	37
6.3	Options on the conflict of laws rule.....	38
6.3.1	Option 1: Law applicable to the assignment contract.....	38
6.3.2	Option 2: Law of the assignor's habitual residence.....	39
6.3.3	Option 3: Law governing the assigned claim.....	39
6.3.4	Option 4: Mixed approach combining the law of the assignor's habitual residence and the law of the assigned claim.....	39
6.3.5	Option 5: Mixed approach combining the law of the assigned claim and the law of the assignor's habitual residence.....	39
6.4	Analysis of impacts.....	40
6.4.1	Impacts of Option 1: Law applicable to the assignment contract.....	41
6.4.2	Impacts of Option 2: Law of the assignor's habitual residence.....	42
6.4.3	Impacts of Option 3: Law of the assigned claim.....	45
6.4.4	Impacts of Option 4: Mixed approach combining the law of the assignor's habitual residence with the law of the assigned claim.....	48
6.4.5	Impacts of Option 5: Mixed approach combining the law of the assigned claim with the law of the assignor's habitual residence.....	50
6.5	Issues raised by stakeholders.....	51
6.6	How do the options compare?.....	52
6.6.1	Stakeholder preferences.....	52

6.6.2	Effectiveness comparison.....	53
6.6.3	Comparison of impacts on the parties concerned.....	53
6.6.4	Cost and coherence comparison.....	54
6.6.5	Overall comparison .....	55
6.6.6	Legal form of intervention .....	58
7	Book-entry securities: options, impacts and who will be affected.....	58
7.1	Screening of options: non-legislative and legislative solutions.....	58
7.2	Descriptions of options retained for analysis .....	59
7.2.1	Baseline: no EU intervention .....	60
7.2.2	Option 1: Choice of law .....	60
7.2.3	Option 2: PRIMA – where the account was opened .....	60
7.2.4	Option 3: PRIMA – where the account is maintained .....	61
7.3	Analysis of impacts .....	61
7.3.1	Baseline .....	62
7.3.2	Impacts of Option 1: Choice of law .....	62
7.3.3	Impacts of Option 2: PRIMA – where the account is opened.....	64
7.3.4	Impacts of Option 3: PRIMA – where the account is maintained .....	64
7.4	How do the legislative options compare?.....	66
7.4.1	Stakeholder preferences .....	66
7.4.2	Effectiveness comparison.....	67
7.4.3	Cost comparison.....	67
7.4.4	How do the legislative and non-legislative options compare?.....	69
8	Impacts of the package of options on claims and securities .....	71
9	How would actual impacts be monitored and evaluated? .....	72
10	Glossary of terms .....	73
	<i>Annex 1: Procedural information.....</i>	<i>77</i>
	<i>Annex 2: Stakeholder consultation strategy .....</i>	<i>80</i>
	<i>Annex 3. Who is affected by the initiative and how? .....</i>	<i>88</i>
	<i>Annex 4. Data sources and quantification of impacts and costs.....</i>	<i>90</i>
	<i>Annex 5. Evaluation of existing Directives .....</i>	<i>94</i>

# 1 INTRODUCTION: POLITICAL, MARKET AND LEGAL CONTEXT

## 1.1 Political context

The Capital Markets Union Action Plan (CMU Action Plan)<sup>1</sup> adopted in 2015 aims to further integrate European capital markets. In line with this objective, this impact assessment examines possible EU action to address the lack of legal certainty in determining the proprietary effects of a transaction in claims or securities, that is, who the owner is of a claim or security further to a cross-border transaction.

In purely domestic transactions it is clear that domestic law applies to determine the proprietary effects of the transaction. In cross-border transactions, however, it is not clear which country's law applies to determine who owns the underlying assets of the transaction. The legal uncertainty in cross-border transactions over who owns the asset results in legal risks. 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.

Given the size of markets and the degree of market integration, legal uncertainty in cross-border transactions is a significant issue when it comes to the enforcement of rights. For individual businesses, compared to domestic transactions, there is an element of legal risk in cross-border transactions. Faced with this legal risk, businesses can choose to ignore it, mitigate it or avoid it, but none of these alternatives will offer an optimal solution to the problem. If businesses decide to ignore the legal risk, they may end up facing unexpected losses. If businesses choose to mitigate the legal risk, they are likely to incur higher costs in cross-border transactions and having to price the risk into the transaction. If businesses choose to avoid the legal risk, they may forego profitable businesses opportunities and hamper capital markets integration.

This problem was identified in 2001 in the Giovannini Report<sup>2</sup>. The European Commission has been monitoring the markets and exploring different ways to address the problem since then.

On claims, there are no common conflict of laws rules at EU level designating the national law that should apply to the proprietary effects of an assignment of claims. As a result, each Member State authority applies its own conflict of laws rules when faced with a dispute over such third-party effects. However, the conflict of laws rules of the Member States are inconsistent and unclear, which leads to the parties involved in the assignment not knowing which national law should govern the third-party effects of the assignment. Given this legal uncertainty, cross-border assignments of claims bear the risk of losses and imply risks for

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<sup>1</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 'Action Plan on Building a Capital Markets Union' ('CMU Action Plan'), COM(2015) 468 final

<sup>2</sup> First Giovannini Report 'Cross-border clearing and settlement arrangements in the European Union - Giovannini Group' (November 2001); available at: [https://ec.europa.eu/info/publications/giovannini-reports\\_en](https://ec.europa.eu/info/publications/giovannini-reports_en), Barrier 15, p. 57–59.

financial stability, or have a higher cost because parties must comply with the requirements of all possibly applicable laws to ensure legal title over the claim and its enforceability. As a result, assignments of claims such as factoring, collateralisation and securitisation are often made on a national rather than on a cross-border basis.

On securities, three directives address the conflict of laws issues on securities: the Financial Collateral Directive, the Settlement Finality Directive and the Winding-up Directive. These directives include conflict of laws rules that cover the most important aspects of securities transactions. These rules were subject to an evaluation, which revealed that their wording is not always clear and gives rise to different interpretations. The purchase and sale of securities as well as their use as collateral take place each day across the EU in huge volumes, and a significant part of these transactions involve a cross-border element. The issue is not therefore the lack of cross-border transactions but the residual legal uncertainty that stems from different national interpretations of the EU rules. In 2003 the Commission proposed the ratification of an international convention on conflict of laws in securities (The Hague Securities Convention), but given the lack of political support this proposal was withdrawn in 2009.

This policy initiative aims at helping to increase cross-border transactions in claims by reducing the legal risks and costs that stem from the current lack of legal certainty. It also aims at addressing the residual legal uncertainty for the very common cross-border transactions in securities. This is in line with the CMU Action Plan, which targets further integration of European capital markets. This impact assessment analyses the impacts of EU action, in line with the CMU Action Plan, to tackle the legal uncertainty over the proprietary effects of cross-border transactions in claims and securities.

The analysis and evidence presented in this impact assessment as well as the conclusions on the preferred options are based on various sources, including feedback from Member States, a Public Consultation with stakeholders, the Expert Group on conflict of laws regarding claims and securities and the European Post Trade Forum (EPTF).

## **1.2 Market context: significant markets for claims and securities but large variations in the cross-border dimension of transactions**

### **1.2.1 Transactions and assets concerned**

This impact assessment deals with transactions in claims and securities. 'Transactions' refers to the sale and purchase of securities and the assignment of claims.

The list of financial instruments in Directive [2014/65/EU](#) on markets in financial instruments<sup>3</sup> ('MiFID II') includes securities (such as shares and bonds), derivatives (such as options or futures) and emission allowances.

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<sup>3</sup> Directive [2014/65/EU](#) of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive [2002/92/EC](#) and Directive [2011/61/EU](#) (recast), OJ L 173/349

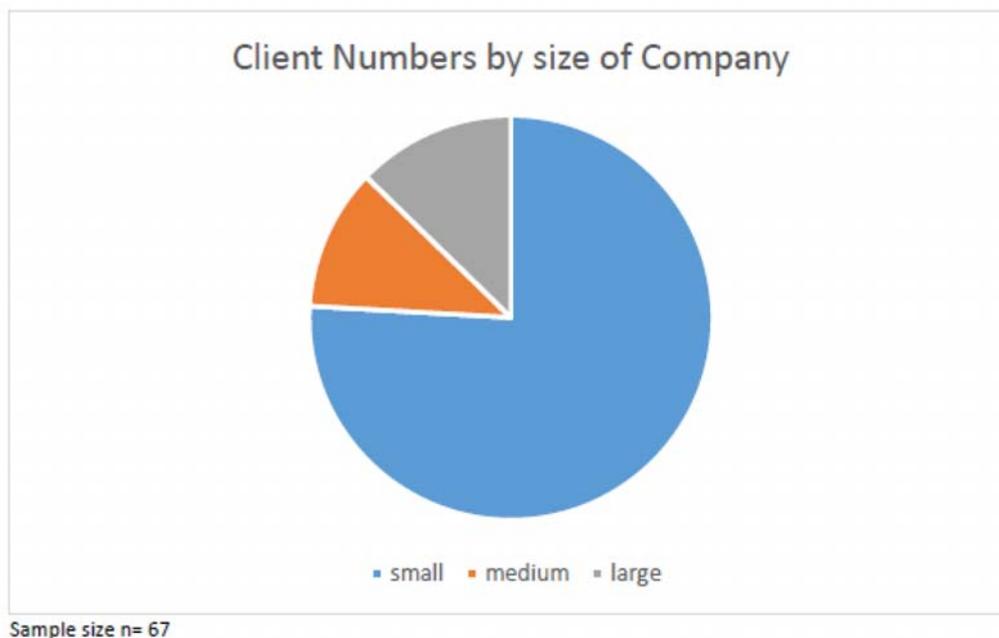
'Claims' refers to any right to payment of a sum of money (e.g. receivables) or to performance of an obligation (e.g. delivery obligation of the underlying assets under derivatives contracts). Claims can be classified into two categories: 'traditional claims' (or receivables, such as money to be received for unsettled transactions) and so-called 'financial claims', that is, claims arising from contracts traded on financial markets, such as derivative contracts.

### 1.2.2 Factoring, which relies on claims, is an important source of financing for firms in the real economy

Factoring is a crucial source of liquidity for many firms. It relies on the assignment of claims: the assignment of receivables by an assignor (for example, an SME) to the assignee (the 'factor', often a bank) at a discount price as a means for the assignor to obtain immediate cash for the receivables it has generated.

The majority of users of factoring by number are SMEs: Small represented 76% of numbers, Medium 11% and Large 13%. Factoring for SMEs is thus regarded by the industry as a basis for economic growth, as SMEs may find sourcing traditional lending more challenging.

Figure 1: Types of factoring clients



Source: EUF<sup>4</sup>

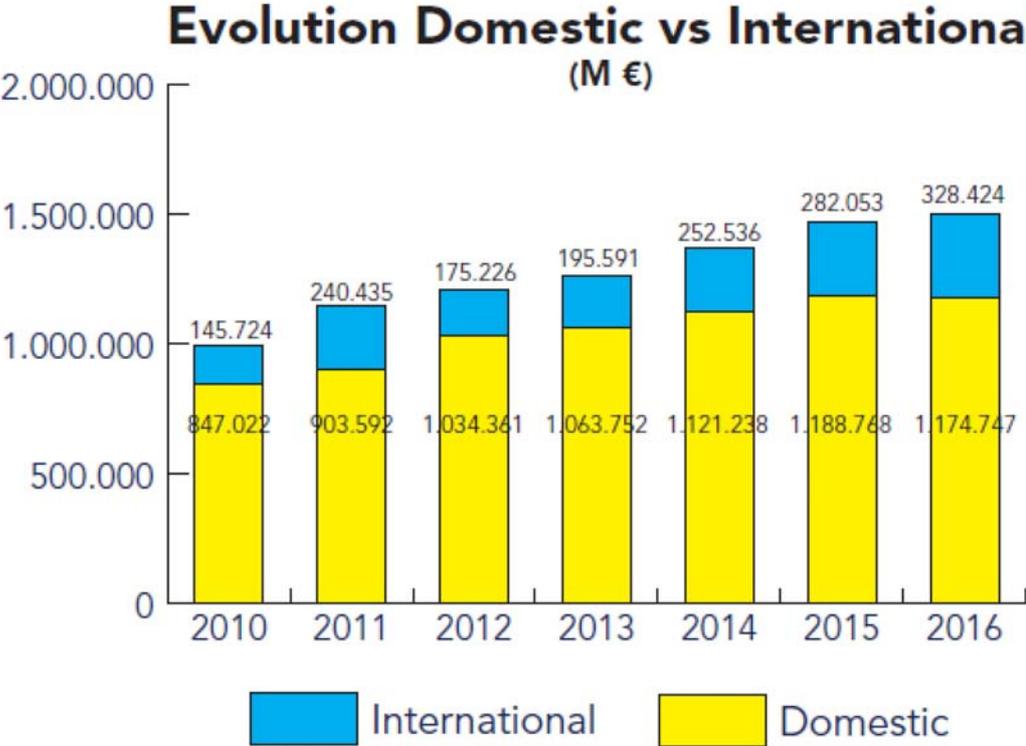
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of 12.6.2014, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065>, applicable as from 3 January 2018.

<sup>4</sup> EUF, Factoring and Commercial Finance: A Whitepaper The EU Federation for the Factoring and Commercial Finance Industry, p. 20.

The dominant type of factoring is domestic and, in 2016, it represented around 78% of total turnover. The long-term trend shows an increase in the proportion of international factoring, although it remains significantly the minority product.

Figure 2: Domestic and international factoring



Source: EUF<sup>5</sup>

Europe is the largest factoring market world-wide, with EUR 1557 billion in 2015, 66% of the world figure. Internationally, domestic factoring accounted for 78% of the total market and international factoring stood at 22% in the same year, which applied to the EU figure would be EUR 342.5 billion.<sup>6</sup> The top European markets are the UK, France, Germany, Italy and Spain.

**1.2.3 Significant markets in collateralisation and securitisation, both relying on claims and securities, allow better access to finance for firms and consumers**

Claims can also be assigned for other purposes, either as financial collateral or as underlying assets in securitisation. Collateralisation and securitisation transform claims into financial collateral or assets, creating an important link between the real economy and finance. With the help of collateralisation and securitisation, firms in the real economy as well as consumers

<sup>5</sup> EUF Yearbook, 2016-2017, p. 13  
<sup>6</sup> Figures refer to Europe as a geographical region, not to the EU 28. Source: Factors Chain International FCI Global Factoring Statistics available at: <https://fci.nl/en/news/global-factoring-volume-reaches-all-time-high-2015/3677>

can get access to cheaper finance. Both areas are therefore of great relevance to financial markets and the real economy. Ensuring that the cross-border element does not contain additional risks is important for these markets to grow in a safe and efficient way.

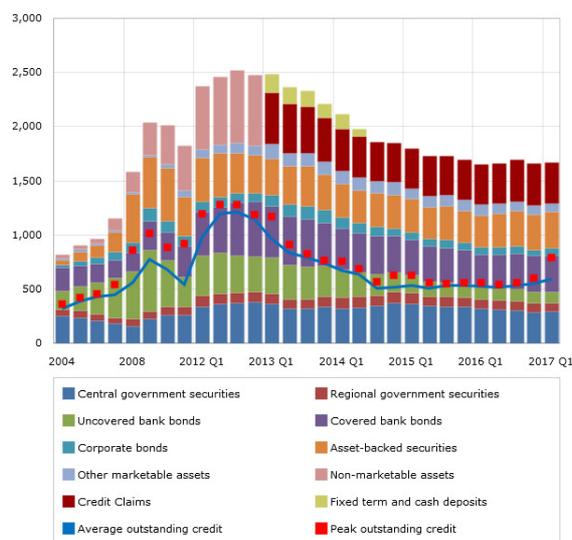
In collateralisation, claims such as cash credited to an account in a credit institution (such as a bank, where the customer is the creditor and the credit institution is the debtor), securities or credit claims (i.e. bank loans) can be used as financial collateral to secure a loan agreement (for example, a consumer can use cash credited to a bank account as collateral to obtain credit, and a bank can use a credit loan as collateral to obtain credit). The collateralisation of credit claims for the financial industry is very important: about **22% of the Eurosystem refinancing operations are secured by credit claims as collateral, amounting to some EUR 380 billion as at Q2 2017, of which about EUR 100 billion represented credit claims mobilised on a cross-border basis. Overall, the Eurosystem had mobilised some EUR 450 billion in cross-border collateral as at end-June 2017.**

Securitisation enables the assignor, called ‘originator’ (e.g. a business or a bank) to refinance a set of its claims (e.g. motor vehicle rents, credit card receivables, mortgage loan payments) by assigning them to a ‘special purpose vehicle’. The special purpose vehicle (assignee) then issues debt securities in the capital markets reflecting the proceeds from these claims. As payments are made under the underlying claims, the special purpose vehicle uses the proceeds it receives to make payments on the securities to the investors. Securitisation can lower the cost of financing because the special purpose vehicle is structured in such a way as to make it insolvency-remote. For corporates, securitisation can provide access to credit at lower cost than bank loans. For banks, securitisation is a way to put some of their assets to better use and free up their balance sheets to allow for further lending to the economy. **The market volume of securitisation issuance was EUR 237.6 billion within the EU in 2016, with EUR 1.27 trillion outstanding at the end of 2016.**<sup>7</sup>

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<sup>7</sup> AFME Securitisation Data Report Q4 2016

Figure 3: ECB data on the use of collateral and outstanding credit



Source: ECB<sup>8</sup>

Cross-border trade in the EU is also substantial in another specific instrument: the EU Emission Trading System (EU ETS)<sup>9</sup> allowances. EU ETS allowances are financial instruments pursuant to MiFID II, as they are included in Annex I, section C, point (11) of this Directive. The EU ETS was established in 2005 as a 'cap and trade' market-based system for the EU Member States and the EEA-EFTA States<sup>10</sup>. Its aim is to reduce emissions of carbon dioxide and other greenhouse gases from the power and industry sector and, since 2012, also from the aviation sector. The EU ETS is the first and still by far largest system for trading greenhouse gas emission allowances. Currently it covers more than 11,000 power stations and industrial plants in 31 countries. The main categories of traders in EU ETS allowances are energy companies and industrial companies that have obligations under the EU ETS, as well as financial intermediaries such as banks which act on behalf of smaller companies and emitters. Today, more than 1,600 intermediaries, traders, organisations and individuals voluntarily participate in the EU ETS. For the period 2005 - 2012, the carbon market grew from around EUR 6 billion annual turnover to up to EUR 90 billion<sup>11</sup>. As of 15 May 2017, the total number of EU ETS allowances in circulation amounted to roughly 1.69 billion allowances<sup>12</sup>.

<sup>8</sup> Notes: EUR billion, after valuation and haircuts. Use of collateral: averages of end of month data over each time period shown; Credit: based on daily data. Since Q1 2013, the category "Non-marketable assets" is split into two categories: "Fixed term and cash deposits" and "Credit claims".

<sup>9</sup> EU Emission Trading System (EU ETS) is established pursuant to Directive 2003/87/EC (ETS Directive) 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, OJ L 275/32 of 25.10.2003, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32003L0087>

<sup>10</sup> Iceland, Lichtenstein, Norway.

<sup>11</sup> See: [https://ec.europa.eu/clima/policies/ets/oversight\\_en](https://ec.europa.eu/clima/policies/ets/oversight_en), FAQ section, Q/A 4.4.

<sup>12</sup> See: [https://ec.europa.eu/clima/news/commission-publishes-first-surplus-indicator-ets-market-stability-reserve\\_en](https://ec.europa.eu/clima/news/commission-publishes-first-surplus-indicator-ets-market-stability-reserve_en)

The largest share of transactions in EU ETS emission allowances is in the form of derivatives (futures, forwards, options), which were already subject to EU financial markets rules prior to MiFID II, but emission allowances are also traded through spot contracts. Emission allowance contracts are concluded either in market venues covered by MiFID II or over the counter. Market venues trading emission allowances tend to be commodity exchanges, which differ from securities-only exchanges in that their participants are not only financial entities but include non-financial entities, that is, industrials or energy companies, which participate directly in the exchange. Equally, since emission allowances may be kept in a Union registry under the ETS Directive, they may be traded bilaterally by non-financials without intermediation by financial entities. They may also be held in custody by financial intermediaries. Emission allowance contracts may be cleared and settled through CCPs or CSDs. Emission allowances (as credits) can be used as collateral and in securitisation arrangements.

The definition, purpose, initial issuance and transferability of EU emission allowances are defined by Directive 2003/87/EC (ETS Directive)<sup>13</sup>, complemented by Commission Regulation 389/2013/EU<sup>14</sup> ('Registry Regulation') and Commission Regulation 1031/2010/EU<sup>15</sup> ('Auctioning Regulation'). The classification of EU emission allowances as financial instruments is made for the purposes of the application of EU financial markets rules and is not aimed at dealing with the legal nature of emission allowances (from the viewpoint of private law) or their accounting treatment.

#### 1.2.4 Transactions in securities are sizeable, with an important cross-border dimension

Securities markets are sizeable and their cross-border dimension is significant. Securities held in Central Securities Depositories ("CSD") accounts across the EU amounted to some **EUR 52 trillion at the end of 2016**, whilst transactions in securities settled through EU CSDs reached the value of **EUR 1128 trillion**.<sup>16</sup>

ECB data suggests that the estimated **volume of cross-border investments**, by residence of the investor, **stood at EUR 10.6 trillion in 2016**.<sup>17</sup>

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<sup>13</sup> 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, *OJL 275 25.10.2003*, p. 32.

<sup>14</sup> 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, *OJL 122, 3.5.2013*, p. 1.

<sup>15</sup> Commission Regulation (EU) No 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowances trading within the Community, *OJL 302, 18.11.2010*, p. 1.

<sup>16</sup> ECB securities settlement statistics (28.6.2017).

<sup>17</sup> There are some limitations to this data, for example exposures to smaller Member States are missing from the data set. Also, it does not take into account the holding chains that can also introduce cross-border elements into a transaction. This means that the estimates based on this data are underestimating the actual size of the relevant market of cross-border transactions in securities.

**Compared to the overall size of securities markets** (EUR 52 trillion of securities held on the accounts of EU CSDs, **this would imply that one in five securities are held by an investor resident in a Member State other than where the securities were issued**, not taking into account of the possible cross-border elements in holding chains. When it comes to country-specifics the situation may vary depending on how attractive the respective market is for investors but in 2014, for example, an estimated 54% of the securities of UK domiciled quoted companies were held by foreign investors.<sup>18</sup>

There are some estimates as to the size of cross-border transactions in securities. These range from 40% to almost all transactions. The Giovannini Report argues that "almost all transactions involve some cross-border element, the laws of more than one jurisdiction are almost always relevant, and therefore an examination is required of the extent to which each legal system recognises the validity of the laws of the other. A more recent study<sup>19</sup> estimates that, **on average, about 40% of all holding, trading and collateral operations by EU market participants involve a cross-border element**. Using the latter estimate and applying it to the EUR 1128 trillion of transactions in securities that were settled in 2016 across the EU means that at least some **EUR 450 trillion worth of transactions in securities had a cross-border element in 2016. In terms of the value of securities held on CSD accounts in the EU at the end of 2016, securities involving a cross-border element can also be approximated in the value of some EUR 20 trillion**<sup>20</sup>. With continuing market integration the relevance of cross-border transactions is expected to grow even further.

### **1.3 Legal context: no EU rules on claims, three EU directives on securities**

Private law, i.e. the law of contract and property, as well as securities law have developed along national lines. Therefore, Member States have different legal solutions to address transactions in claims and securities. When the transaction has a cross-border element, conflict of laws rules apply to determine which national law of all those potentially applicable should apply.

In cross-border transactions in claims and securities two elements are governed by conflict of laws rules: (1) the contractual element, which refers to the parties' obligations towards each other under the transaction; and (2) the proprietary element, which refers to the transfer of rights in property and which therefore affects third parties. EU conflict rules relating to the contractual element exist in relation to claims. EU conflict rules relating to the contractual and proprietary elements exist in certain areas relating to securities. However, no EU conflict of laws rules exist on the proprietary aspect of assignment of claims.

The main difference between the areas of claims and securities is that, while there are no EU conflict of laws rules on the proprietary element of assignments of claims, three Directives include conflict of laws rules on the proprietary element of transactions in securities which, however, are not identically worded.

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<sup>18</sup> Feedback to the public consultation on conflict of laws rules for third party effects of transactions in securities and claims; available at: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

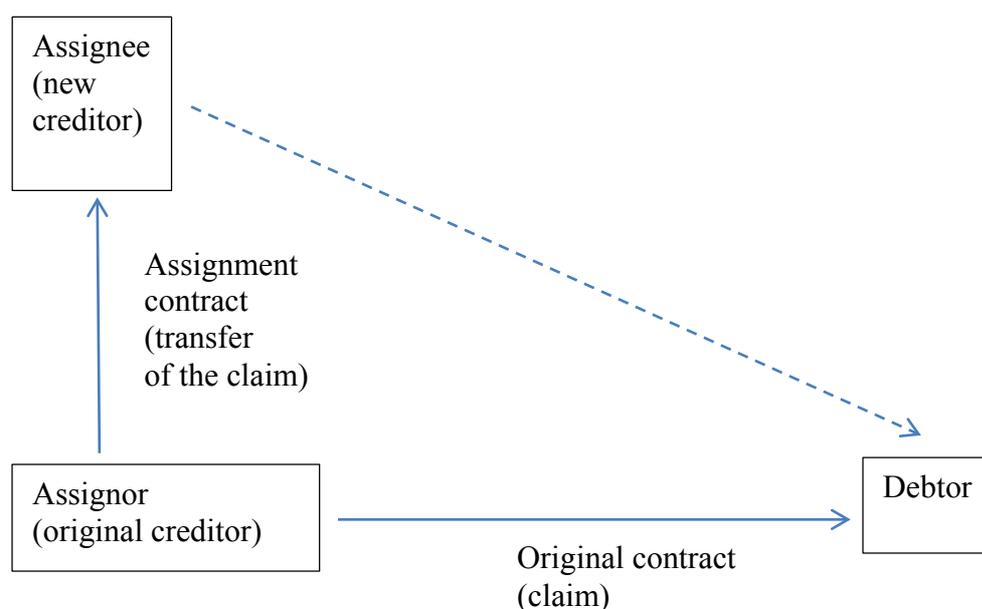
<sup>19</sup> See Paech, P., Market needs a paradigm – breaking up the thinking on EU securities law, in *Intermediated Securities* by Conac, P.-H., Segna, U. and Thevenoz, L. (eds.), Cambridge, 2013.

<sup>20</sup> ECB securities settlement system data.

### 1.3.1 Conflict of laws rules relating to the assignment of claims

A claim is a right to the payment of a sum of money (for example, receivables) or to the performance of an obligation (for example, a delivery obligation of the underlying assets under derivatives contracts).

The assignment of a claim is a legal mechanism whereby a creditor ("assignor") transfers his right to claim a debt against a debtor to another person ("assignee").



An assignment of claims enables both simple transfers of claims from one person to another and complex financial operations used to finance the business activity of firms, such as factoring, financial collateral arrangements and securitisation<sup>21</sup>.

#### ***Example 1: Outright transfer of a single claim***

*Creditor C (assignor) assigns his claim against a debtor to assignee A. A may notify the debtor of the assignment, for instance because the national law of C's place of habitual residence requires notification of the assignment to the debtor to make the assignment effective. A then re-assigns the same claim to assignee B. B may decide not to notify the assignment to the debtor, for instance because, under the law that governs the underlying claim, notification to the debtor is not required to make the assignment effective. C subsequently becomes insolvent and his insolvency administrator tries to ascertain whether*

<sup>21</sup> Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over the right of another person, 29.9.2016 (COM(2016) 626 final).

*assignee A or assignee B is the valid owner of the claim.*

**Example 2: Factoring**

*An SME supplier C (assignor) wishes to assign the bulk of his current and future claims against clients in several Member States to factor A (a bank) which, in return for a discount on the purchase price of the claims, agrees to provide cash flow finance, collect the debts and accept the risk of bad debts. When considering the discount to propose to C, A would need to know whether the assignment will be effective against third parties in the event of C's insolvency. A may also be worried that, while under the law of the assignment contract which governs the proprietary effects between A and C, all claims are assignable, under the law governing some of the claims included in the assignment, bulk assignments may be prohibited.*

**Example 3: Assignment of a claim as security**

*An SME supplier C (assignor) wants to use its claims against the buyers of its products to obtain credit from assignees A and B (banks) using the claims as security. In order to extend credit to C, A and B would need to know who would have priority over the security rights in case of conflict about the title over the same claims. C may also fraudulently assign the same claims to A and subsequently to B without their knowledge. In the event of C's insolvency, the insolvency administrator would need to ascertain whether A or B has priority over the claims.*

**Example 4: Securitisation**

*A large retail chain C assigns its receivables arising from the use by customers of its in-house credit card to a special-purpose vehicle (A)<sup>22</sup>. A then issues debt securities to investors in the capital markets. These debt securities are secured by the income stream flowing from the credit card receivables that have been transferred to A. As payments are made under the receivables, A will use the proceeds it receives to make payments on the debt securities<sup>23</sup>.*

The 1980 Rome Convention and the Rome I Regulation harmonised conflict of laws rules with regard to the **contractual obligations** stemming from an assignment of claims. The Rome I Regulation thus contains uniform conflict of laws rules with regard to (i) the relationship between the parties to the assignment contract - the assignor and the assignee<sup>24</sup>, and (ii) the relationship between the assignee and the debtor<sup>25</sup>. The Rome I Regulation, however, does not include conflict of laws rules with regard to the proprietary effects of the assignment of the claim, that is, the effects on third parties of such assignment. Conflict of

<sup>22</sup> This example is an adaptation of the illustration used in the UNCITRAL Legislative Guide on Secured Transactions, pp. 16-17.

<sup>23</sup> Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over the right of another person, 29.9.2016 (COM(2016) 626 final), p. 5-6.

<sup>24</sup> Article 14(1) of the Rome I Regulation.

<sup>25</sup> Article 14(2) of the Rome I Regulation.

laws rules on the proprietary aspects of assignments of claims are currently laid down in Member State law and not all Member States have actually enacted such rules.

The question of the effects on third parties of assignments of claims was first considered when the Rome Convention was being transformed into the Rome I Regulation<sup>26</sup> and then during the legislative negotiations leading to the adoption of the Rome I Regulation. The Commission proposal for the Rome I Regulation established the law of the assignor's habitual residence as the conflict of law rule applicable to the third-party effects of the assignment<sup>27</sup>. In the legislative process leading to the adoption of the Rome I Regulation, several Member States such as the United Kingdom, the Netherlands, Spain, Portugal and Hungary presented proposals on the law applicable to the third-party effects of the assignment of claims. These proposals included the law of the assignment contract between the assignor and the assignee, the law of the assigned claim or mixed proposals combining the law of the assignor's location as the general rule and the law of the assigned claim as the special rule. Ultimately, no provision on the law applicable to the third-party effects of assignments was included in the final text of the Regulation<sup>28</sup> due to the complexity of the matter and the lack of time to deal with it in the required level of detail.

However, the adopted Regulation specifically acknowledged the significance of this unresolved issue by requiring the Commission to present a report on the question of the effectiveness of assignments of claims against third parties accompanied, if appropriate, by a proposal to amend the Regulation<sup>29</sup>. To this end, the Commission contracted an external study<sup>30</sup> and, in 2016, adopted a report presenting possible approaches to the matter<sup>31</sup>. As observed by the Commission in its report, the absence of uniform conflict of laws rules determining which law governs the effectiveness of an assignment of a claim against third parties and the questions of priority between competing assignees or between assignees and other right holders undermines legal certainty, creates practical problems and results in increased legal costs<sup>32</sup>.

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<sup>26</sup> Question 18 of the Green paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation, [COM\(2002\) 654 final](#), p. 39–41.

<sup>27</sup> Art. 13(3) of the Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), [COM\(2005\) 650 final](#).

<sup>28</sup> Cf. Article 13(3) of Proposal for a Regulation of the European Parliament and of Council on the law applicable to contractual obligations, [COM\(2005\) 650 final](#) and Article 14 of the [Rome I Regulation](#).

<sup>29</sup> Article 27(2) of the Rome I Regulation.

<sup>30</sup> British Institute of International and Comparative Law (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 ('[BIICL Study](#)').

<sup>31</sup> Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over the right of another person, [COM\(2016\) 626 final](#) ('[Commission Report](#)').

<sup>32</sup> [Commission Report](#), p. 12.

### 1.3.2 Conflict of laws rules relating to securities transactions

The Rome I Regulation<sup>33</sup> has harmonised conflict of laws rules with regard to **contractual obligations** of securities transactions. The Rome I Regulation generally allows parties to choose the law applicable to their contractual obligations. This chosen law governs, for example, the interpretation and performance of the contract, the consequences of the breach of obligations, ways of extinguishing obligations and the consequences of nullity of the contract.

As for the **proprietary element** dealing with the transfer of rights in property, three EU Directives contain conflict of laws rules applicable to a subset of transactions in book-entry securities. These Directives use similar but not identical rules. As a result, Member States have implemented and interpreted the rules differently. In contrast with the contractual aspects of securities transactions, no identical conflict of laws rules exist across the EU to determine which national law should govern the proprietary aspects of securities transactions.

The first one of the three Directives is the **Settlement Finality Directive (SFD)**<sup>34</sup>, applicable since 1999. This Directive seeks to ensure that harmonised rules are applied where multiple settlement and payment systems are in operation to avoid difficulties arising from incompatible national regulations. The **Winding-up Directive ('WUD')**<sup>35</sup>, applicable since 2004, contains a conflict of laws rule to govern the enforcement of certain rights in financial instruments, namely those proprietary or other rights the exercise or transfer of which presupposes the recoding of such rights. The SFD and WUD designate the law of the Member State in which the rights are recorded in a "*register, account or centralised deposit system*" as the applicable law. Finally, the **Financial Collateral Directive (FCD)**<sup>36</sup>, applicable since 2003, applies to financial collateral including cash and financial instruments i.e. shares and bonds. As part of the legal framework which it establishes for financial collateral, the Directive contains a provision on conflict of laws<sup>37</sup>: for cases falling within its scope, the applicable law is that of the country where the relevant account is maintained. The FCD defines the 'relevant account' as "*the register or account - which may be maintained by the collateral taker - in which the entries are made by which that book entry securities collateral is provided to the collateral taker*".

Outside the harmonised fields described above, national conflict of laws rules govern the proprietary aspects of transactions in securities. These national rules designate which law is applicable to the proprietary effects of a cross-border transaction in securities to which none of the above-mentioned EU legislation is applicable.

## 1.4 International context: The Hague Securities Convention and the UN Convention on the Assignment of Receivables in International Trade

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<sup>33</sup> Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), OJ L 177/6 of 4.7.2008, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32008R0593>

<sup>34</sup> Directive 98/26/EC on settlement finality in payment and securities settlement systems ('Settlement Finality Directive') OJ L 166/45, 11/6/1998.

<sup>35</sup> 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.

<sup>36</sup> 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.

<sup>37</sup> Art 9(1) of the FCD

#### 1.4.1 The Hague Securities Convention and past attempt to ratify it

The Hague Securities Convention is an international multilateral treaty intended to remove, at a global scale, legal uncertainties for cross-border securities transactions<sup>38</sup>. The text was originally agreed in 2002 and concluded in its current form in 2006. It offers a set of conflict of laws rules principally based on the 'choice of law'. Parties to the account agreement can expressly agree on the applicable law out of the laws of those states where the account provider has an office. In the absence of a valid choice of law, it is the law of the state where the account is maintained that shall govern questions of ownership in book-entry securities.

The Commission proposed in 2003 to ratify the Hague Securities Convention<sup>39</sup>.

In 2006, in an Opinion, the European Central Bank raised concerns about the Convention's ratification and called for a comprehensive prior assessment of the Convention's impact on the European Union, considering that the existing Community regime was sufficiently satisfactory and did not require an urgent or compelling signature of the Convention.

The same year, the European Parliament called in a Resolution<sup>40</sup> for a detailed impact assessment on the implications of accession to the Hague Securities Convention for the law and economy of the European Union. It further requested the impact assessment to specify the fiscal consequences of acceding to the Convention, the implications of the transfer of risks between entities resulting from the abandonment of the PRIMA principle ("place of relevant intermediary approach"), the implications for the exercise of voting rights attached to securities, the effects on the remuneration of the ultimate owner of securities, on combating market abuses, on combating money-laundering and on the funding of terrorism, the effectiveness of clearing and settlement systems and the identification of risks of the insolvency of credit institutions.

In Council negotiations a number of Member States expressed concerns about ratification as well. The concerns that had been raised were analysed in detail in a 2006 Staff Working Document.<sup>41</sup>

The Commission's proposal to ratify the convention was eventually withdrawn in 2009, due to lack of political support and because of the sharp contrast between the approach within the Hague Securities Convention and the EU acquis.

The Hague Securities Convention entered into application in April 2017 in the three states that ratified it, namely the United States, Switzerland and Mauritius. In the near future it is not excluded that further states would ratify the Convention.

There is however no clear/concrete evidence on whether this convention will become an international standard in the near future.

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<sup>38</sup> Available at: <https://www.hcch.net/en/instruments/conventions/full-text/?cid=72>

<sup>39</sup> See: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52003PC0783>

<sup>40</sup> Available at: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2006-0608+0+DOC+XML+V0//EN&language=EN>

<sup>41</sup> Available at: [http://ec.europa.eu/internal\\_market/financial-markets/docs/hague/legal\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/hague/legal_assessment_en.pdf)

## 1.4.2 UN Convention on the Assignment of Receivables in International Trade

The 2001 UN Convention on the Assignment of Receivables in International Trade contains a conflict of law rule on the third-party effects of the assignment of claims. Article 22 of the Convention provides that the law of the State in which the assignor is located governs the priority of the right of an assignee in the assigned receivable over the right of a competing claimant. This rule is subsidiary to matters settled elsewhere in the Convention and is subject to public policy and mandatory rules as well as special rules on proceeds under the Convention.

This conflict of law rule must be read in conjunction with Article 4 of the Convention, which excludes from its scope a number of transactions such as transactions on a regulated exchange, financial contracts governed by netting agreements (except a receivable owed on the termination of all outstanding transactions), inter-bank payment systems, financial assets or instruments held with an intermediary and bank deposits.

The Convention is not yet in force. Luxembourg is the only Member State which has signed it. The Convention has also been signed by the USA, Liberia and Madagascar<sup>42</sup>.

## **2 THE PROBLEM DRIVERS: RULES DESIGNATING THE APPLICABLE LAW ARE INCONSISTENT**

Currently there are no Union conflict of laws rules applicable to the effects on third parties of cross-border assignments of claims. Member State conflict of laws rules thus apply in this area. However, national conflict of laws rules are inconsistent and unclear, thereby creating legal uncertainty.

With regard to securities, three EU Directives contain conflict of laws rules applicable to the proprietary effects of transactions in securities. However, an evaluation of conflict of laws rules relating to securities transactions showed that the rules can be interpreted in ways that are not fully consistent with one another, with a lack of clarity leading to divergent application of the rules of even the same directive.

### **2.1 National conflict of laws rules on the third-party effects of assignments of claims are divergent and unclear, leading to legal uncertainty**

At Member State level, the substantive rules governing the third-party effects of assignments of claims differ greatly. For example, they lay down divergent rules on the following issues: (i) the requirement to notify the debtor to make the assignment effective; (ii) the registration requirements to perfect the assignment; (iii) the assignability of claims; (iv) the order of priority between competing assignees; (v) the determination of the existence of fraud by the assignor if he assigned the same claim more than once without informing the subsequent assignees; (vi) the determination of the moment as of which the debtor should start paying the

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<sup>42</sup> Luxembourg adopted the assignor's location rule in its law of 22 March 2004 on securitisation to align it with the rule in the 2001 UN Convention.

assigned debt to the assignee; (vii) the resolution of a situation in which the debtor faces payment claims from multiple assignees<sup>43</sup>.

In the absence of harmonisation of substantive law, private international law solutions in the form of conflict of laws rules are of crucial importance to resolve cross-border disputes. However, in order to determine the law applicable to the effects on third parties of a claim assignment, Member States also adopt different approaches<sup>44</sup>.

For example, the Netherlands has chosen *the law of the contract between the assignor and the assignee* to apply to the proprietary aspects of a claim assignment. In order to solve the question of priority in case of competing assignments, the law governing the second assignment governs the protection of good faith second acquirers.

The *law of the assignor's habitual residence* governs the third-party effects of a claim assignment in Belgian law. In Luxembourg, in the specific sector of securitisation, the law applicable to the third-party effects of the assignment is also the law of the country in which the assignor is established. The law of the assignor's habitual residence also applies in Switzerland and the US.

The *law governing the assigned claim* is favoured in Spain and Poland. In the absence of a statutory provision, case law and doctrine support this solution in the UK.

Other solutions applied in the Member States are the *lex rei sitae*, that is, the law of the country where the obligation, as an intangible thing, is located or deemed to be located (Czech Republic and Sweden) and the *law of the habitual residence of the debtor* (France). In other Member States, such as Germany, Italy and Finland, there is no clear rule.

The above overview shows how divergent Member States' conflict of laws rules are. As Member States designate different substantive laws to apply to the proprietary effects of a cross-border claim assignment, depending on which court is seized to decide on the matter, the outcome of the case may be quite different. This was also the conclusion of the Expert Group on conflict of laws when examining different national conflict of laws rules on the proprietary effects of assignments of claims.<sup>45</sup> Different substantive rules on the proprietary

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<sup>43</sup> In some Member States (for example, Belgium, the Czech Republic, Finland, Germany, Italy, Poland, the Netherlands, England), in cases of competing assignees, priority is given to the first assignee. In England and the Netherlands, the relevant time for effectiveness against third parties is the notification of the assignment to the debtor. In England, assignment of claims as security by way of a charge or mortgage needs to be registered with the Registrar of Companies. Several Member States do not require a notice or any type of registration for an assignment to be effective against third parties (for example Belgium, the Czech Republic, Germany, Poland, Spain and England), while others require a notice to the debtor (for example, France, Luxembourg) or the acceptance by the debtor in an authentic act (for example, Italy) - Report from the Commission to the European parliament, the Council and the European Economic and Social Committee on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over the right of another person, 29.9.2016 (COM(2016) 626 final), p. 5-6.

<sup>45</sup> Minutes of the Expert Group meeting of 15-16 May 2017, available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=33452&no=2>

effects of claim assignments may also lead market participants to forum shopping in an attempt to have the national substantive rules most favourable to their interests apply to their cross-border assignment.

***Example of legal uncertainty in a situation of collateralisation involving claims in a cross-border context***

*There may be legal uncertainty as to the law applicable to the proprietary effects of an international claim assignment where a Belgian credit claim is provided as collateral by a Spanish collateral giver (the assignor) to the Belgian central bank (the assignee). The Belgian central bank might rely on its own Belgian conflict of laws rule, under which the law of the collateral provider's habitual residence, i.e. Spanish law, applies. Based on this assessment, the Belgian central bank will comply with the formal requirements under Spanish law to ensure the enforceability of the claim against third parties (for example, a competing assignee or a creditor of the Spanish collateral giver). If the credit claim had also been wrongfully assigned by the Spanish assignor to another assignee, questions of priority would arise between the Belgian central bank and the second assignee. The Belgian central bank would assume that it has priority because formal requirements under Spanish law have been complied with, while the second assignee may base its assessment on, e.g., the Spanish conflict of laws rules under which the law governing the claim, i.e. Belgian law, is applicable. Thus, the second assignee will rely on the formal requirements of Belgian law and also believe that it has priority over the rights of the Belgian central bank.*

***Example of legal uncertainty in a situation of factoring or securitisation of claims in a cross-border context***

*The question as to whether an assignment of claims is enforceable against third parties is crucial in securitisation transactions, factoring and, more generally, any financing that is secured or backed by claims. The creditors of the assignor (in case of the assignor's insolvency) need to know whether claims which could otherwise be included in the insolvency estate have been properly assigned and the legal title over the claims thus transferred. Competing assignees need to know who will have priority rights in case the same claim has been assigned more than once.*

*1. Assignors can be located in several jurisdictions. The determination of the law applicable to the third-party effects of the assignment of claims is conducted in each jurisdiction where an assignor is located based on the assumption that the judge dealing with the bankruptcy of the assignor is likely to be located in the same jurisdiction. This legal analysis may be costly depending on the number of jurisdictions involved.*

*2. Debtors can be located in several jurisdictions and therefore the assigned claims may be governed by the laws of different jurisdictions (including local laws applied for mandatory reasons, such as consumer laws). Depending on the number of jurisdictions involved, this could impair the feasibility of a bulk assignment of claims as third parties would have to look*

*at the laws of several jurisdictions, which may be impracticable for assignees and lessen transparency for the creditors of the assignor*<sup>46</sup>.

The examples illustrate the legal risks stemming from the diverging Member State conflict of laws rules combined with the absence of a uniform conflict of laws rule at Union level. This situation leaves market participants with high uncertainty as to which of the very different national substantive rules applies to their cross-border assignment of claims and thus as to whether their assignment is effective and can be enforced against third parties.

## **2.2 EU conflict of laws rules relating to securities are interpreted differently across Member States**

The evaluation of conflict of laws rules relating to securities transactions contained in three directives (FCD, SFD and WUD) showed that these rules can be interpreted in ways that are not fully consistent with one another (see Annex 5). The lack of clarity in each of these directives leads to a divergent application of the rules of even the same directive.

Although all three directives use a similar rule, the solutions differ in detail. Depending on which Member State's authorities are deciding about a proprietary issue, they might reach a different conclusion as to which law is applicable even if they are looking at the same case.

The first and most apparent issue is that the wording of the directives leaves open **how to determine where the account is 'located'** (wording used by the SFD and the WUD) or **'maintained'** (wording used by the FCD). The directives do not specify whether 'location' means something different than 'maintenance' and whether those terms refer to legal or factual connecting factors. As the Evaluation in Annex 5 also shows, Member States interpret these concepts differently. Divergences of interpretations were found not only across the different directives, but also in the case of one single Directive. For example the wording of the FCD "where the account is maintained" is interpreted in at least six different ways.

Further residual differences across the three directives can be observed, namely that the wording of the SFD and the WUD leaves open **which 'record' is relevant** in case a book-entry security is recorded simultaneously in a "*register, account or centralised deposit system*".<sup>47</sup> The FCD uses the term **'country'**, whereas the other two directives refer to **'Member States'** only. The FCD relies on the notion of **'book-entry securities collateral'**, which is based on a self-standing definition of **'financial instruments'**<sup>48</sup>, whereas the SFD and the WUD rely on the list of 'financial instruments' annexed to the MIFID II<sup>49</sup>. Finally, whereas the FCD excludes *renvoi*,<sup>50</sup> the other two directives do not.

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<sup>46</sup> Responses to the Public Consultation on conflict of laws rules for third party effects of transactions in securities and claims, available at: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>47</sup> Although the FCD provides more guidance at first sight as it defines the 'relevant account', the definition seems circular as referring to the account in which the entry of the collateral provision has to be made and this very issue depends in turn on national securities law which the conflict of laws rule still needs to determine.

<sup>48</sup> Points (e) and (g) of Article 2(1) of the Financial Collateral Directive.

<sup>49</sup> Article 9(2) in conjunction with point (h) of Article 2 of the [SFD](#); Article 24 in conjunction with indent 11 of Article 2 of the WUD. These dynamic references have now to be read as references to section C of Annex

The above issues imply some theoretical legal uncertainty.

## 2.3 Scope and methodology

### 2.3.1 Which legal issues are unclear?

#### 2.3.1.1 Claims and securities: the proprietary aspects of transactions

As explained above, the contractual aspects of transactions in claims and securities are governed by the Rome I Regulation and are outside the scope of this impact assessment. This analysis does not therefore deal with the question of which law should govern the original contract between the parties. In particular, this report does not examine the transfer of the contracts (such as derivative contracts), in which both rights (or claims) and obligations are included, or the novation of contracts including such rights and obligations. As this report does not cover the transfer of contracts or the novation of contracts, trading in financial instruments, as well as the clearing and the settlement of these instruments, are not examined as these are subject to the law applicable to contractual obligations as laid down in the Rome I Regulation. This law is normally chosen by the parties to the contract or is designated by non-discretionary rules applicable to financial markets. This report only examines the question of which law should govern the proprietary aspects of the assignment of claims or the transaction in securities.

#### 2.3.1.2 Claims: effectiveness of the assignment of claims and priority issues

With regard to claims, the effects on third parties of an assignment of claims essentially refer to two types of issues: (a) the effectiveness of the assignment of the claim against third parties, that is, the steps that need to be taken by the assignee to be able to oppose his right over the claim to third parties – for example, registering the assignment with a public authority or registering or notifying the debtor in writing of the assignment; and (b) priority issues: that is, in case of successive assignments of the same claim, the determination of whose right has priority – for example, between competing assignees of the same claim or between an assignee and another right-holder, for example a creditor of the assignor or a creditor of the assignee in insolvency cases.

#### 2.3.1.3 Securities: different wording and interpretation across Member States

With regard to securities, the three Directives address already the most relevant aspects of cross-border transactions to provide legal certainty. However, the different wording and the

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I to Directive 2014/65/EU. For example, there might be varying views as to whether ‘registered shares’ (i.e. shares which exist in book-entry form but the transfer of which takes place by registration in the issuer's shareholder registry) are covered by the notion of ‘book-entry securities’. In addition, market practice differs in respect of which financial instruments are being credited to a ‘securities account’, depending on national legal and regulatory requirements. In some Member States exchange-traded derivatives are credited to ‘securities accounts’, in others they are rather being evidenced in ‘other records’ of an intermediary. As a result, the scope of conflict of laws rules may vary across the Union.

<sup>50</sup> ‘*Renvoi*’ is a legal technique where a jurisdiction's conflict of laws rule does not only designate another country's substantive law to be applicable, but also the other country's conflict of laws rules, which might refer back to the law of the original jurisdiction.

different application of the same rules at national level create some uncertainty as to which law applies.

### 2.3.2 Transactions and assets concerned

The transactions covered by this impact assessment are the sale and purchase of securities and the assignment of claims.

The list of financial instruments in MiFID II includes securities (such as shares and bonds), derivatives (such as options or futures) and emission allowances. With regard to securities, and given that issues concerning the applicable law only arise in cross-border transactions, this impact assessment looks into those securities in which cross-border transactions are frequent. Some securities, notably securities which are not recorded in book-entry form, are not frequently subject to cross-border deals. Therefore, the scope of this analysis is limited to book-entry securities.

As to claims and as explained above, they can be classified into two categories: 'traditional claims' (or receivables, such as money to be received for unsettled transactions) and so-called 'financial claims', that is, claims arising from contracts traded on financial markets, such as derivative contracts, which are financial instruments under MiFID II.

Claims arising from contracts which are financial instruments under MiFID II, such as derivative contracts, are relevant for the proper functioning of financial markets. Similarly to securities, these contracts constitute large volumes of cross-border transactions and are often recorded in book-entry form. From an economic viewpoint, markets in these assets and the interests of stakeholders dealing with these assets are similar to those in markets in securities.

The form of recording trade in derivatives, that is, whether in book-entry form or otherwise, is governed by Member State law. In some Member States certain kinds of derivatives are recorded in book-entry form and are regarded as securities while, in other Member States, they are not. Depending on whether or not, under national law, a derivative is recorded in book-entry form and regarded as a security, the authority or court dealing with a dispute over the ownership of the financial instrument or of the claim arising therefrom will apply the conflict rule applicable to book-entry securities or the conflict rule applicable to claims.

In view of the above, this impact assessment assesses the impact of the planned initiatives on claims and securities and, more specifically, on: (i) 'traditional claims' as well as 'financial claims' arising from contracts not recorded in book-entry form, both of which are referred to as 'claims' in this report; and (ii) securities in book-entry form and 'financial claims' arising from contracts recorded in book-entry form, both of which are referred to as 'securities' in this report.

### 2.3.3 Methodology and access to data

The analysis and evidence presented in this impact assessment is based on various sources. The most relevant include the EPTF Report<sup>51</sup>, the findings of the T2S Harmonisation Steering Group, feedback received from Member States to a Questionnaire on national transposition of relevant EU rules<sup>52</sup>, a Public Consultation with stakeholders, and discussions within the Expert Group on conflict of laws regarding securities and claims. Detailed information on the process can be found in the Annexes to this report.

#### 2.3.3.1 Confidentiality of the number and value of assignments of claims

In practice, although the value of financial claims, that is, claims arising from contracts traded on financial markets (for example, derivatives), is recorded by trading or clearing market infrastructures, in particular trade repositories, this information is confidential. In addition, it is not possible to have information on the number of claim assignments or on whether such assignments were of a domestic or cross-border nature as this information is not recorded.

As regards traditional claims, that is, receivables, the value of claims assigned with the involvement of the factoring industry is confidential. In addition, it is not possible to know the number of claims assigned or whether such assignments are cross-border or domestic as this information is not recorded. It is also not possible to have any information on the value, number or character (cross-border or domestic) of claims assigned between private parties without the involvement of the factoring industry, such as claims assigned between businesses, between businesses and consumers or between consumers only, as this information is not recorded by any public or private organisation.

In the public consultation with stakeholders, both the authorities of Member States and the stakeholder associations that replied to the public consultation confirmed that a great deal of data on assignments of claims, for example on collateralisation or securitisation, is not collected either by public authorities, stakeholders or stakeholder associations.

#### ***Example of lack of access to data regarding cross-border transactions in claims***

*"[There is] no publicly available information about many of these transactions. AFME is not aware of any existing industry-wide initiative to collect this information from firms. For AFME members, claims are often used as underlying assets in securitisations. Information about public transactions can be found in AFME's Securitisation Data Report. However, it is very difficult to estimate the total number or value of transactions concerned per year, since in addition to public transactions there are many private transactions and for these there is no publicly available information".<sup>53</sup>*

<sup>51</sup> The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en)

<sup>52</sup> See the results in Annex 5 containing an evaluation of the conflict of laws provisions governing proprietary aspects of securities transactions in three EU Directives.

<sup>53</sup> Feedback to the public consultation on conflict of laws rules for third party effects of transactions in securities and claims available at: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

In view of the above, data on the number, value and cross-border character of claim assignments, including both recorded and non-recorded assignments, in a given year within the EU, cannot be obtained. Data of a general nature on the value of assignments of claims in the markets of factoring, collateralisation and securitisation is provided in sections 1.2.2 and 1.2.3.

#### 2.3.3.2 Unclear understanding on the interpretation of EU rules for transactions in securities

With regard to securities, the public consultation revealed that, out of 39 respondents, 16 thought it was not clear how to apply EU rules, 10 considered the rules were clear, and 13 did not provide a reply. Court cases revealing actual problems in applying the existing rules are rare and stakeholders could not supply any evidence (either on court cases or out-of-court settlements) of legal uncertainty causing substantial problems in practice. Attempts to collect evidence of the impact of legal uncertainty in securities transactions only delivered a general cost estimate for legal opinions, which cover, among other things, an analysis of the applicable law.

### **3 THE PROBLEM: CROSS-BORDER TRANSACTIONS ARE INHERENTLY RISKIER THAN DOMESTIC ONES**

#### **3.1 The legal risk in cross-border transactions leads to potential losses (with stability risks), higher costs and reduced market integration**

As explained above, the law that applies to cross-border transactions cannot always be clearly determined, which means that the validity and enforceability of these transactions is often uncertain. Currently, cross-border transactions are inherently riskier than purely domestic ones because, for example, the effectiveness of proprietary rights over the securities or claims may be disputed by market participants which are not party to the transaction. Matters can get more complicated where several subsequent transactions take place and certain players call previous transactions into question (for example, because registration requirements were not complied with, securities were not acquired in good faith, or bulk assignments of future claims were not effective in the assignor's insolvency). Questions of priority may also arise where competing claimants exist because the same assets were wrongfully assigned multiple times to different recipients. If a transaction takes place domestically, there is usually no problem in answering these questions based on national substantive law but, in a cross-border situation, it is frequently unclear which national substantive law applies.

The problem tree below shows the main drivers, the problem and its consequences. The problem stems from the fact that the rules designating the law applicable to the proprietary effects (that is, the ownership and the rights of the owner) of cross-border transactions are unclear and inconsistent. There is legal uncertainty as to which law will be deemed applicable by a given court or authority that has to determine who has ownership rights over certain assets in a cross-border transaction. If investors, credit providers or factors are unable to determine in advance which national substantive law governs their rights, they risk not having validly acquired the claims or the securities. Cross-border transactions in claims and securities might therefore bear significant legal risk, as technical defects may emerge as to the manner in which the transaction was carried out, possibly resulting in serious financial loss for those

that put money at risk in the transaction<sup>54</sup>. The analysis in this impact assessment aims to examine how material this problem is in practice and how it differs in the area of claims and securities.

**Market participants might react to the legal risk in cross-border transactions in three different ways: by ignoring it, mitigating it or avoiding it if they are deterred by the legal uncertainty.** Depending on how they choose to deal with it, the legal risk in cross-border transactions will have different consequences for market participants: (i) if they ignore the risk, it may materialise during the insolvency proceedings of a counterparty: the validity or the enforceability of a transaction might then be challenged, leading to losses, where systemic risk implications cannot be excluded with **broader implications for financial stability risk**; (ii) if market participants choose to mitigate the legal risk posed by legal uncertainty by seeking additional and specialised legal counsel, the transaction bears additional costs, making **cross-border transactions more costly than domestic ones**; (iii) if market participants are deterred by the legal risk posed by legal uncertainty and choose to avoid it, they may lose business opportunities and **jeopardise the integration of capital markets under the CMU initiative**.

The above assumes that market participants are in fact aware of the legal risk, a condition which is in fact often not met<sup>55</sup>. In these cases market participants will remain oblivious to the risk. This will, on the one hand, reduce the detrimental effect in terms of reduced market integration given that the cross-border transaction will be carried out as initially intended. On the other hand, this situation can give rise to hidden business risks for which the trading entity cannot plan or safeguard itself against.

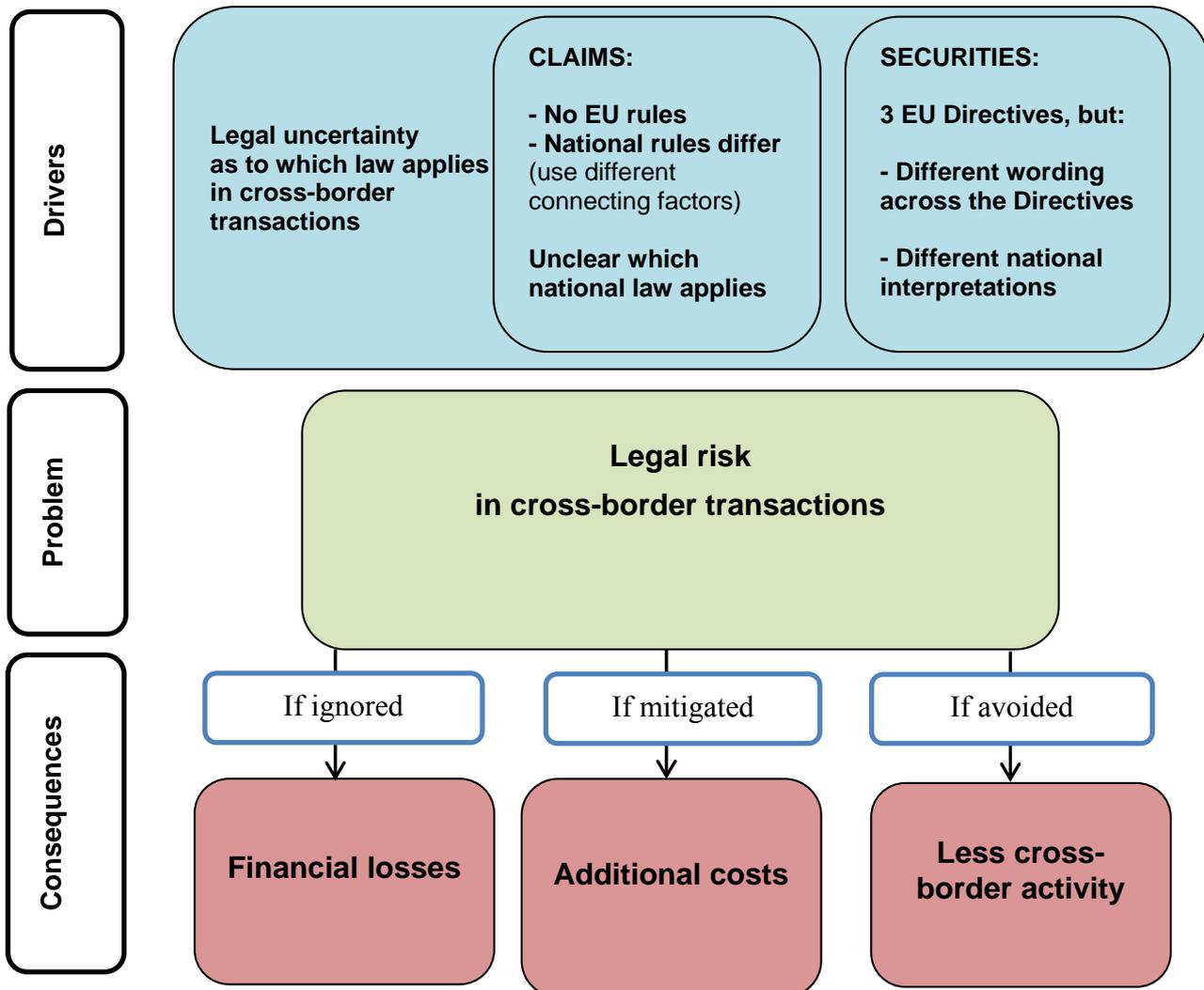
This impact assessment does not calculate risks of losses and the likelihood of systemic impacts according to an econometric model. This would require tracing all bilateral transactions, both reported and private, and preparing a legal assessment of each of those transactions to find out what percentage of these are exposed to the legal risks of different laws being applicable and in what way each specific case could be decided differently depending on where the case is heard. Since tracing all transactions and getting specific legal assessment for all of them is impossible, this analysis instead substantiates the problems through, first, a summary of a detailed analysis of applicable laws both at EU and national levels and, second, provides quantitative estimates on cross-border transactions in claims and securities across the EU. Putting the two together, the extent to which there are legal inconsistencies and the extent to which transactions involve cross-border elements will be used as a proxy to estimate the magnitude of the problem: the legal risk in cross-border transactions.

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<sup>54</sup> This is the definition of ‘legal risk’ employed by R. McCormick, *Legal risk in the financial markets*, Oxford 2010, p. 21.

<sup>55</sup> Giovannini Report and Public consultation of stakeholders

## Problem tree



### 3.2 Proprietary effects of assignments of claims: absence of EU conflict of laws rules and inconsistent national conflict of laws solutions

The total absence of EU conflict of laws rules in respect of the proprietary effects of assignments of claims and the inconsistent national conflict of laws solutions create legal uncertainty as to which law applies to such third-party effects. This uncertainty means that there is a risk in cross-border transactions that the assignment may not be valid, may not confer all the rights the assignee expects or that the assignment may not be enforceable against third parties.

- Legal uncertainty in the context of cross-border transactions in both claims and securities was raised by several respondents to the public consultation on the Green

Paper “Building a Capital Markets Union”<sup>56</sup>, where a very broad range of stakeholders called on the European Commission to improve legal certainty in cross-border securities holdings.

- The expert group European Post Trade Forum (EPTF), in its 2017 Report<sup>57</sup>, flags this issue as still one of the barriers to an efficient EU post-trade market, recognising that the issue does not relate only to conflict of laws rules applicable to transactions in securities but also to assignments of claims.
- The Expert Group on conflict of laws analysed in detail the existing legal uncertainty in cross-border transactions in both claims and securities, and proposed alternative ways of clarifying which law is applicable to the third-party effects of transactions in claims and securities.

Despite the legal uncertainty reported by stakeholders and experts, court cases are quite rare in this field given the risk of reputational damage to the litigating parties in front of courts, where details of the cases are publicly disclosed. Very often parties prefer to resolve problems of legal uncertainty in out-of-court settlements, the details of which are not public, and therefore it is not possible to obtain evidence as to how often problems of legal uncertainty lead to out-of-court resolution between parties. However, in the face of financial distress, avoiding litigation is very difficult and case law concerns major frauds and insolvencies. It is therefore usually for the insolvency administrator or resolution authority to answer the question ‘who owns what’ in order to establish which claims and securities form part of the insolvent institution's estate.

### **3.3 Proprietary effects of transactions in securities: residual legal uncertainty**

Experts and at least some stakeholders agree that, despite the existence of conflict of laws rules, residual legal uncertainty remains – as also evidenced in the evaluation, and the public consultation where 16 stakeholders pointed out that it was not clear how to apply EU rules. However as it is clear from the data on the size of cross-border securities transactions (see section 1.2.4.), this residual legal uncertainty did not prevent the development of significant cross-border markets. Market participants found ways to deal with the different application of EU rules, either through exhaustive legal opinions (one third of those stakeholders who answered thought that the question of applicable law was always adequately addressed in cross-border transactions), or by structuring their transactions in a way that creates legal certainty. Possibly they might also price in any remaining legal risks, however there is no evidence whether and how often this might happen.

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<sup>56</sup> In total 19 respondents argued for the need to improve legal certainty in cross-border securities holdings. The responses that are not anonymous are available at: <https://ec.europa.eu/eusurvey/publication/capital-markets-union-2015?surveylanguage=en>

<sup>57</sup> The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en)

### 3.4 Ignoring the risks can lead to losses

#### 3.4.1 Important risks relating to the assignment of claims

An example was given by the Asset Based Finance Association Limited (ABFA) outlining the risks relating to the assignment of claims:

*"The risks to ABFA Members when purchasing cross border receivables are:*

- 1) that their ownership of receivables, even though valid in UK and Ireland, will not be recognised under the law of the country in which the debtor is located and thus make the debt uncollectable from the debtor;*
- 2) that a third party may have a prior right to the debt thus making the debt uncollectable;*
- 3) that if the assignee trader is located outside UK and Ireland the asset based finance provider's ownership of the debt may not be accepted by the assignee trader's insolvency official."*<sup>58</sup>

Besides the concrete examples received through the public consultation, the argument is also made that market participants are often not aware of the legal risks at all. The public consultation asked stakeholders ***whether or not legal opinions always cover the question of the applicable law when relevant***. While 20% of respondents did not provide an answer, only 25% of respondents thought that the question of applicable law was adequately addressed in all relevant situations. Almost 50% of respondents thought legal opinions do not always assess the applicable law where such question would be relevant for the transaction. Also, the Giovannini Group in its 2001 Report already notes that:

*"The risks associated with legal certainty are rarely if ever acknowledged or accommodated in the transaction. [...] Participants only become aware of the risk when a problem with enforcing ownership claims actually arises."*<sup>59</sup>

In addition, the cost of a cross-border assignment of claims may be prohibitive due to the aforementioned legal uncertainty as to the law applicable to the third-party effects, both in situations where the transaction is too small or too complex. In such cases, legal due diligence costs may be waived and risks taken or ignored.

*"The "legal due diligence" issues account for an average of 50 % of the lawyers' fees for a typical cross-border transaction, but can also be so prohibitive that the parties agree to take the legal risk of not carrying on a comprehensive legal due diligence. This obviously creates a legal risk that could be avoided by harmonizing the conflict-of-law rules. [...] On one side, if the cost of these studies is too high, the transaction may not be carried out. On the other side, if nonetheless banks decide to carry out the transaction without running all the legal due*

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<sup>58</sup> Ibid.

<sup>59</sup> Giovannini Report, p. 55.

*diligence, the legal risk may be very important. [...] Legal due diligence may not be followed for small and very simple deal*".<sup>60</sup>

### 3.4.2 Theoretical risks of losses with no material evidence for transactions in securities

In terms of risk of losses with regard to securities the literature and the public consultation did not deliver any tangible evidence. Theoretically the legal risk, if ignored, can lead to unexpected losses. Whether and how often this happens in practice is unclear. Parties would likely settle such issues out of court, and such settlements are confidential. Therefore, there is no publicly available data to quantify these risks. Given, however, that legal uncertainty in respect of securities is marginal compared to legal uncertainty in claims – due to the existence of EU conflict of laws rules on securities – risks of losses in securities transactions are also likely to be more marginal than in the case of claim assignments.

### 3.5 Mitigating risks means higher costs for cross-border transactions

If market participants choose to mitigate the legal risk posed by legal uncertainty, they will incur additional costs.

#### 3.5.1 The significant cost of cross-border assignments of claims

The absence of uniform conflict of laws rules on the proprietary effects of cross-border assignments of claims leads market participants to having to obtain several legal opinions as to the requirements under all potentially applicable national laws or to structure their transactions along existing legal inconsistencies and comply with the requirements of all potentially applicable national laws. This can double or triple the cost of a cross-border transaction<sup>61</sup>. Market participants that are aware of the legal risk and choose to mitigate it are likely to price it in the transaction. The costs of legal opinions can be reduced to some extent by aiming to obtain one legal opinion for several transactions that are standardised, but this is only of limited help.

When asked in the Public Consultation whether problems had been encountered in practice in securing the effectiveness of cross-border assignments of claims against persons other than the assignee and the debtor in the past five years, 11 stakeholders replied that they had faced problems, 5 stakeholders responded negatively and 21 either did not know or did not respond.

Nearly all stakeholders agreed that legal due diligence undertaken for cross-border assignments of claims represents important costs. Although costs vary greatly from case to case, they constitute at least 25% of the legal fees, but frequently 40% (and up to 60%) of the legal fees for banks, as transactions often involve several debtors located in different Member States. This requires the analysis of each law potentially applicable, in particular the law of the assignor's habitual residence, which is almost systematically examined to ensure

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<sup>60</sup> Feedback to the public consultation on conflict of laws rules for third party effects of transactions in securities and claims; available at: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>61</sup> Minutes of the Expert Group meeting of 19-20 April 2017, available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=33066&no=2>

protection in the event of the assignor's insolvency. Stakeholders also mentioned that, if the costs of legal advice on the applicable law are too high, the transaction may not be carried out at all (see quote in Section 3.4.1 above).

The Expert Group on conflict of laws provided examples from law firms specialised in transactions in claims about the costs that parties involved in collateralisation, securitisation and factoring need to incur to obtain legal opinions on all possibly applicable laws:

*"We ran through an Asset Based Loan (ABL) transaction with 28 jurisdictions obtaining 28 local opinions to ensure enforceability against third parties of the assignment of claims as security ranging from 10,000 to 15,000€ (depending on the jurisdictions)."*

*"We recently advised on a pan-European trade receivables securitisation involving 18 jurisdictions. Although the majority of them were located in Central Europe, more than 10% of the overall transaction costs were allocated to the due diligence, advice and coordination of the foreign local lawyers (in order to obtain a local memo on the formalities to be performed locally, according to their local law, for enforceability of the assignments towards third parties). [...]"*

*"We also set up a supply chain programme for a similar number of jurisdictions and the third country enforceability analysis was the most difficult to obtain. The overall fees were in the range of more than 500.000€ (including the tax analysis) only for the local law analysis"*

*"We recently advised a factoring company, operating in cross-border transactions, in the establishment of a trade receivables platform structured to cover more than 60 jurisdictions. The issue of the enforceability of the transfer vis-à-vis third parties was one of the main topics that we had to analyse - with the support of foreign counsels/experts - for the setting-up of the platform. This issue determined: - a significant impact in terms of timing; - a substantial amount in legal fees payable by the client for the setting-up of the platform (approx. 25/30% of the total fees were allocated to this part of the analysis (i.e. enforceability of the transfer vis-à-vis third parties)) [...]."*

### 3.5.2 Residual legal risk relating to transaction in securities

With regard to securities, the residual legal uncertainty can in theory have a transaction cost. One estimate puts the additional cost linked to "legal discrepancies" at 22%, noting however that this figure cannot be taken at face value, given that "there is general or residual legal risk inherent in cross-border transactions that cannot be eliminated" and which are therefore not related to the residual legal uncertainty as to which law applies.<sup>62</sup> Combining the 22% estimate with EU securities settlement system data as at end-2016 and survey-based data obtained by Oxera<sup>63</sup>, yields an overall annual cost estimate of some EUR 13 billion.<sup>64</sup>

<sup>62</sup> See Paech, P., *Market needs a paradigm – breaking up the thinking on EU securities law*, in *Intermediated Securities* by Conac, P.-H., Segna, U. and Thevenoz, L. (eds.), Cambridge, 2013.

<sup>63</sup> See *Monitoring prices, cost and volumes of trading and post-trading services*, Report prepared for the European Commission by Oxera, London and Brussels, 2011.

However, as pointed out above, it **cannot be established** what proportion of these costs stem from the legal uncertainty that this impact assessment is focusing on. In addition, within this figure **there is no detailed breakdown of** transactions with EU and non-EU counterparties that would allow us a better estimate of the cost of legal uncertainty within the EU compared with non-EU counterparties.

**As such, the costs relating to theoretical legal uncertainty are to be considered as minimal/residual.**

Mitigating residual risks in cross-border securities transactions can also take the form of commissioning legal opinions. The European Banking Federation estimates the costs of standard legal opinions to be between EUR 10 000 and EUR 50 000<sup>65</sup>, however it is unclear which part of the costs are created by conflict of laws questions:

*"Where the questions and issues covered by the opinion are intended to address specific concerns of an institution or their specific structure, (bespoke) agreement or adjusted standard agreement, or even individual transaction, the cost may well be significantly higher.*

- A completely new opinion (on a new type of standard agreement and in relation to a new set of legal issues/questions) is a very time consuming and complex endeavor: the first opinion to be obtained will thus always be considerably more expensive than a revised version (update) of a previous opinion or an opinion where the relevant issuer of the opinion has already issued other opinions on similar legal questions.*
- Likewise, an opinion covering more complex legal issues (segregation and custodian relationship may be one example) will be more challenging and thus more expensive."*

As these are general figures for legal opinions that are necessary for each transaction whether or not conflict of laws are clear or unclear, there is no estimate of the specific costs of assessing conflict of laws issues. Therefore, **it is not possible to give a precise cost estimate of the residual legal uncertainty in securities transactions.**

### **3.6 Avoiding the legal risk leads to less cross-border activity**

With regard to **claims**, if market participants are deterred by the legal risk and choose to avoid it, **they will not enter into certain cross-border assignments**, which will result in lower levels of cross-border activity in the EU.

At central bank level, the Eurosystem takes credit claims as collateral for about 25% of financial market transactions (see Section 1.2.3). But clarity over which law is applicable to the third party-effects of the collateral assignment is a prerequisite for the claims to be accepted as collateral. One of the conditions for credit claims to be accepted as collateral by

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<sup>64</sup> Some EUR 6 billion of this aggregate figure can be attributed to the increased cost of clearing and settlement of cross-border securities transactions, whilst the remaining EUR 7 billion relate to account provision and asset servicing on a cross-border basis.

<sup>65</sup> Source: EBF written contribution to the EPTF discussions, dated 4 November 2016. "This estimate is based on our experience with an opinion program for four different types of master agreements and covering more than 20 jurisdictions (netting opinions in view of Art. 295 CRR), a set of opinions on export credit agency protection in view of Art. 194 CRR and legal opinions on specific legal issues in respect of custodians."

the Eurosystem is that there cannot be more than two different laws applicable to (a) the counterparty; (b) the creditor; (c) the debtor; (d) the guarantor (if relevant); (e) the credit claim agreement; and (f) the mobilisation agreement.<sup>66</sup> Uncertainty around which law is applicable to the third-party effects of the claim assignment increases the risk of potentially more than two laws being applicable. This means that some credit claims cannot be assigned as collateral within the Eurosystem.

With regard to **securities**, it appears that cross-border markets have developed despite the residual legal uncertainties, as evidenced in section 1.2.4. The choice of avoiding the legal risk is therefore not pertinent for securities.

### **3.7 Various market participants are affected negatively**

Legal uncertainty has different consequences for different types of players.

#### **3.7.1 Companies, including SMEs**

Having a uniform and clear conflict of laws rule designating the national law applicable to the third-party effects of a claims assignment would make it easier for companies, including SMEs, to obtain finance in exchange for claims assigned as collateral. For example, if the national law designated as applicable by the conflict of laws rule allows companies to offer to banks future claims against non-domestic customers as collateral, or to offer such claims in bulk as collateral, companies could design their business accordingly and thereby have easier access to cheaper finance.

#### **3.7.2 Factoring and securitisation industry**

With regard to **claims**, the factoring and securitisation industries currently operate according to national conflict of laws rules on the third-party effects of assignments of claims where these exist, or try to structure transactions avoiding cross-border elements because the Member States from which they operate do not always have clear conflict of laws rules.

The adoption of common and clear conflict of laws rules would have a positive impact on the conditions under which banks offer their financing and securitisation services based on claims held by domestic firms against non-domestic customers, and the conditions under which the factoring industry offers their discounting services to SMEs (that is, the purchase of the SMEs' unpaid claims). If there was legal certainty as to which national law applies to the third-party effects of claims assignments, costs for legal due diligence for cross-border transactions could be abolished and the enforcement of cross-border claims facilitated. The factoring and securitisation industries could thus provide their services to companies, including SMEs, under more favourable terms.

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<sup>66</sup> Article 97 of the Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline) (ECB/2014/60) (recast)

As for **securities**, the residual legal uncertainty does not seem to impede the development of cross-border transactions. It might make the structuring of transactions or legal opinions marginally more expensive, but there is no precise data as to these additional costs in either existing literature or responses from stakeholders.

### **3.8 How would the problem evolve, all things being equal?**

Without any action at EU level it is unlikely that the problems posed by the legal risk derived from legal uncertainty would be resolved in the near future. Any action by Member States is likely to result in a continuation of the application of different conflict of laws rules, as Member States are unlikely to converge on one single conflict of laws rule. This means that the status quo with its current problems would remain.

In respect of the proprietary effects of assignments of **claims**, no EU conflict rules have been adopted. This leaves cross-border assignments of claims subject to multiple potentially applicable Member State laws based on different connecting factors and covering different scopes. The legal uncertainty stemming from this situation creates a legal risk that can either be ignored by the parties to cross-border assignments, mitigated at the expense of higher transaction costs or result in missed profitable business opportunities and reduced market integration. The legal risk stemming from the current legal uncertainty is likely to remain unchanged absent any EU intervention.

With regard to **securities**, Member States alone cannot address the divergent application of existing EU rules. In the medium term, technological developments such as distributed ledger technology<sup>67</sup> can be expected to gain further ground in financial services. Such technological advances would not resolve legal uncertainty. On the contrary: as conflict of laws rules are unclear or conflicting, legal uncertainty might stand in the way of applying these new technologies, which require clearly defined rules to facilitate the recording of transactions and the verification of whether or not a transaction is valid.

## **4 WHY SHOULD THE EU ACT? LEGAL BASIS, SUBSIDIARITY AND ADDED VALUE**

In the area of judicial cooperation in civil matters with cross-border implications, Article 81(2)(c) of the Treaty on the Functioning of the European Union (TFEU) empowers the Parliament and the Council to bring measures, where necessary, to ensure the compatibility of the rules applicable in the Member States concerning conflict of laws and of jurisdiction.

Pursuant to Protocol No 22 to the TFEU, legal measures adopted in the area of freedom, security and justice, such as rules on conflict of laws, do not bind or apply in Denmark. Pursuant to Protocol No 21 to the TFEU, the UK and Ireland are also not bound by such measures. However, once a proposal has been presented in this area, these Member States can

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<sup>67</sup> A distributed ledger is essentially a record of information, or database, that is shared across a network. It may be an open, publicly accessible database or access may be restricted to a specified group of users. It can be used to record transactions across different locations. Individual transactions are stored in groups, or blocks, which are attached to each other in chronological order to create a long chain, and is secured to protect the integrity of the data. This chain then forms a register of transactions that its users consider to be the official record. See more on DLT in: ECB "Distributed Ledger Technology" in focus issue 1, 2016 available at: [https://www.ecb.europa.eu/paym/pdf/infocus/20160422\\_infocus\\_dlt.pdf](https://www.ecb.europa.eu/paym/pdf/infocus/20160422_infocus_dlt.pdf)

notify their wish to take part in the adoption and application of the measure and, once the measure has been adopted, they can notify their wish to accept that measure<sup>68</sup>.

With respect to the third-party effects of assignments of **claims**, each Member States currently has (i) its own substantive rules, and (ii) its own conflict of laws rules designating which substantive law applies to such third-party effects. Both the substantive rules and the conflict of laws rules of the Member States are different (and in a number of cases the conflict of laws rules are unclear or not laid down in statutory legislation), and this divergence creates legal uncertainty which results in legal risk, as the substantive laws of various countries can potentially apply to one cross-border assignment.

In order to provide legal certainty, the EU could propose to harmonise the substantive rules of all Member States governing the third-party effects of assignments of claims or to harmonise the conflict of laws rules applicable to the third-party effects of assignments of claims. The solution proposed is to provide legal certainty through the harmonisation of conflict of laws rules. This is a more proportionate solution in line with the subsidiarity principle as it does not interfere with national substantive law and only applies to assignments of claims with a cross-border element.

Such action relating to the third-party effects of assignment of claims would be suitable to achieve the objective of providing legal certainty for cross-border assignments and, at the same time, not go beyond what is necessary to achieve the aim of facilitating cross-border investment, access to cheaper credit and greater market integration. It would provide market operators with clear rules on the law that will apply to a certain assignment without embarking on the more intrusive path of harmonising the laws of Member States.

There would be clear added value in addressing the problems described at EU level rather than through individual action by Member States. In respect of claims, this is supported by 80% of the stakeholders consulted in the study contracted by the Commission, which expressed a need for legislation on the law applicable to the third-party effects of assignments of claims<sup>69</sup>. The public consultation also tested the opinion of stakeholders with regard to the added value of EU action. Out of the 39 stakeholders that responded to the question, 59% answered positively, 22% did not see any added value and 18% did not have an opinion. Member States acting individually could not satisfactorily remove legal uncertainty, the legal risks stemming from inconsistent national conflict of laws rules and the ensuing barriers to cross-border investment and access to credit, as national rules and procedures would need to be the same or at least compatible in order to work in a cross-border situation.

The added value of EU action in this field would be the unification across the EU of the conflict of laws rules applicable to the third-party effects of cross-border assignments of claims. Action at EU level would ensure that, throughout the Union, the same national substantive law is designated as the law applicable to the third-party effects of a claim assignment and, thus, that the designated national law applies regardless of the Member State whose courts are seised. The legal certainty around the law applicable to the proprietary rights

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<sup>68</sup> Protocol 21 to the TFEU, Articles 3 and 4.

<sup>69</sup> BIICL Study, p. 24.

of the parties to cross-border assignments of claims would bolster cross-border investment and facilitate access to credit for companies and consumers.

For **securities**, clarification of certain aspects of the existing EU conflict of laws rules is needed because Member States acting individually cannot achieve a consistent application of the rules. It is necessary to improve the transparency of the existing rules, to address the residual legal uncertainty and to improve legal certainty for cross-border transactions given the divergent implementation of these rules at national level.

## 5 WHAT SHOULD BE ACHIEVED?

### 5.1 The policy objectives

The general objective of this initiative is, in line with the objectives of the CMU Action Plan, to foster cross-border investment in the EU and, thereby, facilitate access to finance for firms, including SMEs, and consumers. More specifically, this initiative aims to improve legal certainty in order to: (i) reduce the financial losses resulting from materialised legal risks; (ii) eliminate the costs incurred by market participants when trying to mitigate the legal risks stemming from legal uncertainty; and (iii) make it simpler and more attractive for market participants to carry out cross-border transactions in the EU.

Legal certainty can be improved by ensuring that the same national substantive law is designated as the law applicable to the proprietary effects of a given cross-border transaction in claims or securities, irrespective of which Member State's authorities are competent to review the matter.

The following table shows how the specific objective links to the problem identified and its drivers:

	<b>PROBLEMS</b>	<b>OBJECTIVES</b>	
<i>Driver</i>	Legal uncertainty: -no EU rules and inconsistent national rules (claims) -unclear and differently implemented EU rules (securities)	Have uniform EU rules (claims) Have clarity of EU rules and their implementation (securities)	<i>Operational</i>
<i>Problem</i>	Legal risk	Improve legal certainty	<i>Specific</i>
<i>Consequences</i>	Losses Costs Less cross-border activity	Reduce losses Reduce costs Foster cross-border investment (for claims)	<i>General</i>
<i>Size or scale of problem</i>	Significant for claims Residual for securities	Substantial for claims Marginal for securities	<i>Size or scale of expected improvement</i>

## 5.2 Consistency with other EU policies and the Charter for fundamental rights

The aims of the initiative are coherent with other EU policies, in particular financial market regulation and judicial cooperation in civil matters. By harmonising conflict of laws rules on the third-party effects of assignments of claims, this initiative would clarify the legal situation of parties involved in factoring, collateralisation and securitisation and thereby facilitate access to finance for SMEs and consumers. Regarding financial market regulation, the initiative is part of the Capital Markets Union Action Plan, which aims, among other things, to facilitate cross-border investment. With the objective to reduce the legal risk stemming from legal uncertainty that may discourage cross-border transactions or lead to additional costs, this initiative would contribute to the objective of encouraging cross-border investment.

Another key objective of the current initiative is to reduce the losses that might occur when legal uncertainty is ignored. This objective is fully consistent with the objective of investor protection set out in a number of EU financial market regulations.

With regard to the Charter of Fundamental Rights of the European Union,<sup>70</sup> the objectives of the initiative are in full support of the provision on the right to property (Article 17), which provides in paragraph (1) that:

*"Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest."*

Indeed, by clarifying which law is applicable to assess the proprietary aspects of transactions in claims and securities, the current initiative would greatly contribute to upholding the Charter's right to property, as it would diminish the risk that investors or collateral takers' ownership over claims or securities might be hindered.

In addition, by reducing cases of fall-outs and financial losses due to the complex and unclear provisions on the law applicable to the proprietary effects of transactions in claims and securities, this initiative would positively impact the freedom to conduct a business set out in Article 16, which provides that:

*"The freedom to conduct a business in accordance with Union law and national laws and practices is recognised."*

Finally, by unifying conflict of laws rules relating to the proprietary effects of transactions in claims and securities, this initiative would discourage forum shopping as any Member State court hearing a dispute would base its judgement on the same national substantive law. This would facilitate the right to an effective remedy set out in Article 47, which provides in its first sentence that:

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<sup>70</sup> Charter of the Fundamental Rights of the European Union, OJ C 326 of 26/10/2012, p. 391.

*"Everyone whose rights and freedoms guaranteed by the law of the Union are violated has the right to an effective remedy before a tribunal in compliance with the conditions laid down in this Article."*

## **6 CLAIMS: OPTIONS, IMPACTS AND WHO WILL BE AFFECTED**

### **6.1 Baseline: no EU intervention**

The baseline scenario against which all options are measured is the status quo. The expected evolution of the status quo is described in section 3.8.

The special objective of this initiative is to provide legal certainty so as to eliminate the problem of legal risk and its consequences of possible losses and increased transaction costs, and thereby reach the general objective of fostering cross-border investment. Maintaining the status quo would not achieve any of these objectives.

### **6.2 Harmonising conflict of laws rules**

With the increasing interconnectivity of national markets, assignments of claims often involve a cross-border element which can lead to a conflict of applicable laws. Legal certainty as to which law applies to the different relationships created by the assignment is paramount for the smooth running of assignment operations. Increased legal certainty leads to a greater number of assignments and, therefore, to an increased availability of capital and credit across borders; more affordable credit rates, particularly beneficial for small and medium-sized enterprises (SMEs) and, in the long run, to facilitating the cross-border movement of goods, services and capital<sup>71</sup>.

The CMU Action Plan acknowledges that developing a pan-European capitals market could benefit from reviewing the provisions related to the assignment of credit claims and the order of priority of such transfers. Given that the objective of EU intervention is to provide legal certainty in order to do away with the problems posed by legal risk, it is considered necessary for such EU intervention to take the form of a legislative instrument harmonising the conflict of laws rules applicable to the third-party effects of assignments of claims. The adoption of non-legislative action would not eliminate the current legal uncertainty as each Member State would be entitled to continue to apply and interpret its own conflict of laws rules.

The harmonisation of the conflict of laws rules would not entail an additional layer of rules for market participants or Member States. Instead, it would streamline and simplify the current situation where parties to a claim assignment must look at and comply with a number of potentially applicable national laws, as the EU common conflict rules would replace the existing diverging national conflict rules. In this way, parties to a cross-border claim assignment would only need to look at the EU common conflict rules to know: (i) which national law lays down the requirements they need to comply with in order to ensure that they

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<sup>71</sup> Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over the right of another person, 29.9.2016 (COM(2016) 626 final), p. 2.

will acquire legal title over the claim, and (ii) which national law will apply to resolve a dispute over the legal title of the claim.

### **6.3 Options on the conflict of laws rule**

In any cross-border assignment of claims, third parties must be able to identify the law applicable to the effects of the assignment so that they can ascertain their rights or obligations. The national substantive law designated by the chosen conflict of laws rule as the law applicable to the third-party effects of the assignment must govern the matters<sup>72</sup> not governed by the Rome I Regulation, namely:

- (i) the effectiveness of the assignment of the claim against third parties: that is, the steps that need to be taken by the assignee in order to be able to oppose to third parties his right over the claim – for example, registering the assignment with a public authority or registry, or notifying the debtor in writing of the assignment; and
- (ii) priority issues: that is, in case of successive assignments of the same claim, the determination of whose right has priority – for example, between competing assignees of the same claim or between an assignee and another right-holder, for example a creditor of the assignor or the assignee in insolvency cases.

The term ‘third parties’ should be understood as third parties other than the debtor, as all aspects affecting the debtor are, pursuant to Article 14(2) of the Rome I Regulation, governed by the law that governs the assigned claim.

The study contracted by the Commission shows<sup>73</sup> that the laws most commonly applied today to resolve conflicts of laws on the effects on third parties of assignments of claims are the following: the law of the contract between the assignor and the assignee (for example, the Netherlands), the law of the assignor's habitual residence (for example, Belgium, Luxembourg in respect of securitisation) and the law governing the assigned claim (for example, Spain, Poland). These options will be analysed hereafter together with two mixed options which combine the law of the assignor's habitual residence and the law of the assigned claim. The mixed options, which consist of a law applicable as a general rule and another law applied to some situations as an exception, aim at taking into account the specific needs of market participants.

#### **6.3.1 Option 1: Law applicable to the assignment contract**

Under this connecting factor, the law that governs the contract of assignment between the assignor and the assignee would also govern the proprietary effects of the claim assignment<sup>74</sup>. The assignor and the assignee can choose any law to govern their assignment contract.

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<sup>72</sup> Minutes of the Expert Group meeting of 13-14 July 2017. Available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3506>

<sup>73</sup> BIICL Study (2012), pp. 12-14.

<sup>74</sup> For example, Art. 10:135(2) of the Dutch Civil Code specifies that the property law regime with regard to the transfer of, or creation of, a right in a claim is the law applicable to the contract in accordance with which the assignment or establishment of the right is made. It codifies the Dutch Supreme Court decision in

### **6.3.2 Option 2: Law of the assignor's habitual residence**

Under this connecting factor, the third-party effects of the assignment of claims would be governed by the law of the country in which the assignor has his habitual residence.

### **6.3.3 Option 3: Law governing the assigned claim**

Under this connecting factor, the third-party effects of a claim assignment would be governed by the law that governs the assigned claim, that is, the credit in the original contract between the creditor and the debtor which is subsequently assigned by the creditor (assignor) to a new creditor (assignee). The parties to the original contract can choose any law to govern the contract which includes the claim subsequently assigned.

### **6.3.4 Option 4: Mixed approach combining the law of the assignor's habitual residence and the law of the assigned claim**

This mixed option combines the application of the law of the assignor's habitual residence as a general rule and the application of the law of the assigned claim to certain exceptions, namely (i) the assignment of cash credited to an account in a credit institution (such as a bank, where the consumer is the creditor and the credit institution is the debtor), and (ii) the assignment of claims arising from financial instruments such as, for example, derivative contracts. This mixed option also lays down the possibility for the assignor and the assignee to choose the law of the assigned claim to apply to the third-party effects of assignments of claims in the context of a securitisation. The possibility for parties in a securitisation to remain subject to the general rule based on the law of the assignor's habitual residence or choose the law of the assigned claim aims at catering for the needs of both large and smaller securitisation operators.

### **6.3.5 Option 5: Mixed approach combining the law of the assigned claim and the law of the assignor's habitual residence**

This mixed option combines the application of the law of the assigned claim as a general rule and the application, as an exception, of the law of the assignor's habitual residence to the assignment of multiple and future claims.

Under this option, the third-party effects of the assignment of trade receivables by a non-financial company (for example, an SME) in the context of factoring would remain subject to the law of the assignor's habitual residence. The third-party effects of the assignment of multiple claims by a financial company (for example, a bank) in the context of securitisation would also be subject to the law of the assignor's habitual residence.

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the case *Hansa/Bechem*, in which the Supreme Court interpreted Article 12 of the 1980 Rome Convention (Supreme Court (*Hoge Raad*), 16 May 1997, ECLI:NL:HR:1997:ZC2373).

## 6.4 Analysis of impacts

The options on the law applicable to the proprietary effects of cross-border assignments of claims will be analysed as to their effectiveness in reaching the specific objective of providing legal certainty. Providing legal certainty will eliminate the legal risk that may result in losses and increased transaction costs and achieve the general objective of promoting cross-border investment. Legal certainty is ensured by applying the same conflict rule throughout the EU (and, if possible, also at international level) so that the same substantive law governs the proprietary effects of a cross-border assignment irrespective of where within the EU (and preferably also at international level) a court examines a dispute.

The options will also be analysed as to the cost of their implementation for the transacting parties and for the third parties affected by the cross-border assignment.

In connection with the law applicable to the third-party effects of assignments of claims, the analysis of the impacts of each option from the point of view of its effectiveness and costs of implementation requires an examination of the following elements: (i) its predictability and its capacity to apply to future claims; (ii) its impacts on the parties concerned by the claim assignment (that is, the assignee, who needs to know which requirements he must satisfy to acquire legal title over the claim, and third parties such as creditors of the assignor or the assignee or competing assignees), and (iii) its costs (in particular the legal costs linked to bulk assignments of claims) and the consistency with other EU provisions and international solutions.

Predictability refers to the possibility for the assignee to easily know which law sets out the formalities that he must comply with to be able to oppose his right to third parties (for example, registration of the assignment or notification to the debtor), and to the possibility for the assignee and other right-holders over the same claim to easily know which law will apply to resolve a priority conflict (for example, between two assignees when the assignor has successively assigned the same claim, or between an assignee and a creditor of the assignor in case of the assignor's insolvency).

Consistency with other EU provisions refers to the compatibility of each option with other EU conflict of laws rules that apply in situations where the third-party effects of assignments of claims need to be ascertained, namely the Insolvency Regulation<sup>75</sup>, which applies in cases of insolvency of the assignor or the assignee.

Consistency with international solutions refers to the compatibility of each option with the conflict of laws rules on the third-party effects of the assignment of claims adopted at international level, namely the 2001 UN Convention on the Assignment of Receivables in International Trade.

The issues raised by stakeholders during the consultation process will also be addressed.

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<sup>75</sup> Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, OJ L 141, 5.6.2015, p. 19–72.

## 6.4.1 Impacts of Option 1: Law applicable to the assignment contract

### **Effectiveness in reaching the objectives**

The law that governs the contract between the assignor and the assignee can extend also to the third-party effects of the assignment and determine how to perfect the transfer of the right over the claim. This allows the parties to the assignment contract to choose a legal system that recognises the particular type of security interest they wish to create, or to have one law govern all transfers when they seek to assign a pool of claims governed by different laws<sup>76</sup>.

This option provides legal certainty for the parties to the transaction through which the claim is transferred or the collateral created. For example, in certain financing transactions, where the collateral taker (the assignee, for example a bank) intends to create a valid collateral interest in the claim, the uncertainty regarding the applicable law is minimised between the assignor and the assignee if they only need to agree on the applicable law between themselves. In such situation the same law applies to the contractual aspects and the proprietary aspects of the assignment and the distinction between property aspects as between the parties and against third parties becomes obsolete<sup>77</sup>.

However, this option would not provide any predictability for parties other than the assignor and the original assignee (for example, a creditor or a subsequent assignee) as to which law would govern their interests in the claim.

### **Impacts on the parties concerned**

The law that applies to the assignment contract cannot be predicted ex-ante by the third parties that may be affected by the assignment because, under Article 14(1) of the Rome I Regulation, which governs the relationship between the assignor and the assignee, the parties can choose the law that should govern their relationship under the assignment contract. This option thus entails a lack of legal certainty for third parties as to the law that governs the assignment contract and therefore as to the law that would also apply to them.

In addition, choosing the law of the assignment contract to apply to the third-party effects of the assignment does not take into consideration the interests of third parties, such as creditors or competing assignees. Applying the law of the assignment contract can negatively affect the rights of third parties by creating a possibility of fraud (for example, in relation to the assignor's creditors in a situation of insolvency of the assignor) or by avoiding publicity requirements which may provide essential information to creditors and competing assignees.

This option would not take into account that assignments of claims arising from financial instruments such as, for example, derivative contracts, should be governed by the law of the assigned claim and, therefore, by the law of the financial instrument itself.

### **Costs and coherence with existing EU acquis and the international solution**

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<sup>76</sup> F.J. Garcimartín, in Magnus/Mankowski, *European Commentaries on Private International Law* 2017.

<sup>77</sup> BIICL Study, 2011, p. 386.

A conflict of laws rule that would impose the law of the contract between the assignor and the assignee as the law applicable to the third-party effects of the assignment could lead to an increase in the number of cases where the outcome of a dispute resolved under this law would be in conflict with (i) the public policy laws of the jurisdiction of the debtor, (ii) the property laws of the jurisdiction of the debtor, and (iii) the property laws of a jurisdiction under which the third party had acquired rights over the underlying debt. The costs linked to disputes in or outside court would not therefore significantly decrease under this option.

The option of choosing the law of the assignment contract as the law applicable to the third-party effects of the assignment would not be consistent with the EU conflict of laws rules applicable to insolvency, laid down in the Insolvency Regulation and based on the law of the centre of main interest of the insolvent business (COMI). This option would also be inconsistent with the conflict of laws rule contained in the 2001 UN Convention, which opts for the law of the assignor's habitual residence.

#### **6.4.2 Impacts of Option 2: Law of the assignor's habitual residence**

##### **Effectiveness in reaching the objectives**

The option of applying the law of the assignor's habitual residence to the third-party effects of the assignment provides a greater degree of predictability than the law that governs that assignment contract or the law that governs the assigned claim. Indeed, the location of the assignor provides a connecting factor that is ascertainable in advance by all parties concerned, including third parties, such as creditors of the assignor and potential second assignees, without the need to conduct a due diligence on the law that applies to the assigned claims or the contract of assignment. This option facilitates bulk assignments of claims, permits the assignment of future claims and supports global security assignments and securitisation.

##### ***Example of a priority conflict between two assignees and its solution under a conflict of laws rule based on the assignor's habitual residence***

*An Austrian company (A) assigns a receivable against a German customer (C) to a German Bank (B) as security for a loan given by Bank B to A. One day later, A assigns the same receivable to Bank X in Austria, again as a security for a loan given by Bank X to A. A enters only the second but not the earlier (first) assignment into its books (so-called "Buchvermerk", a prerequisite under Austrian law for a security assignment to be effective against third parties). Alternatively, Bank X asks C (the debtor) whether he has been notified of an assignment and, the debtor denying it, A notifies C of the assignment to X (debtor notification is an alternative way of perfecting the security assignment under Austrian law). Under the assignor's habitual residence approach, both assignees (the two banks) would have known from the beginning that Austrian law was applicable, so that the priority conflict would be decided by the time of perfection (book-entry or notification, whichever comes first). The first*

*bank B would have been able to comply with Austrian law and thereby make it possible for X to know about the first assignment*<sup>78</sup>.

The location of the assignor also provides a connecting factor ascertainable in advance where the contract out of which the receivable is going to arise has not yet been concluded at the time of the assignment. In other words, a conflict rule based on the assignor's habitual residence makes possible the assignment of future claims. The assignor's location rule thus facilitates financing against future receivables, such as global security assignments and retention of title agreements which extend the seller's security rights to the proceeds of sub-sales. Both kinds of financing transactions are extremely common in Member States such as Germany and France.

### ***Example of assignment of multiple claims***

*In France assignment of future receivables arising from contracts not yet concluded is very common in bank financing and securitisation deals. The French Dailly law, for instance, implemented in 1981 to facilitate credit to companies, expressly provides for the assignment or pledge of receivables arising from a contract that is "not yet concluded and whose amount or maturity is not yet known"<sup>79</sup>. The French securitisation law also has a similar express provision to allow securitisation of future receivables (e.g. arising from season tickets, cell phone subscription or electricity subscription, etc.)<sup>80</sup>.*

### **Impacts on the parties concerned**

The law of the assignor's habitual residence would increase the possibility of obtaining financing for enterprises, including SMEs, as it would allow them to offer their future claims against non-domestic clients as a security to the banks which provide them with credit. At the same time, the law of the assignor's habitual residence would be beneficial for enterprises, including SMEs, wishing to sell their claims against non-domestic clients to the factoring industry which the factoring industry could, in turn, treat more easily and with lower costs. Companies as well as the factoring industry would, thus, be positively impacted by the application of the assignor's law. Also, some quarters of the banking industry believe that the law of the assignor would decrease due diligence costs and enable European banks to offer more competitive deal to their clients.

The securitisation industry is divided as to the effects of applying the assignor's law to securitisation activities: certain members of this industry consider the law of the assignor's habitual residence as the most beneficial conflict of laws rule as it would allow the expansion of securitisation transactions involving claims governed by laws of multiple countries. Other members of the securitisation industry see a negative impact of applying the assignor's law to securitisation transactions due to the possible problem of enforceability resulting from the

<sup>78</sup> Flessner/Verhagen, Assignment in European Private International Law, 2006, p. 33 et seq.

<sup>79</sup> Art. L.313-23 of the French Monetary and Financial Code.

<sup>80</sup> Conflict of laws rules for the third party effects of transactions in claims, Expert subgroup on conflict of laws on claims, 6 June 2017, p. 9.

discrepancy of the law applicable to third-party effects and the law applicable to the claim and thus to the debtor.

This option would ignore that assignments of claims arising from financial instruments such as, for example, derivative contracts, should be governed by the law of the assigned claim and, therefore, by the law of the financial instrument itself.

### **Costs and coherence with existing EU acquis and the international solution**

In the case of an assignment of a high number of low value claims, an examination of each individual receivable in a bulk in order to determine the necessary steps to render its acquisition effective against third parties is costly and time-consuming. Moreover, in receivables purchase programs, where the assignments are made on a large number of claims (usually of a small amount) and on a weekly or even daily basis (which is typically the case for receivables purchase programs by conduits), it is not even possible in practice to carry out a due diligence each time a claim is assigned<sup>81</sup>. The law of the assignor would enable third parties to look at a single law instead of having to investigate potentially a large number of individual contracts governed by different laws<sup>82</sup>. In specific sectors, such as securitisation, where securitisers need to look at the laws that govern each claim assigned in a bulk, the law of the assignor's habitual residence would not represent additional costs as, already now, securitisers need to check the law of the assignor's location when evaluating whether to buy a portfolio of claims due to possible registration requirements imposed by that law<sup>83</sup>.

In factoring and securitisation deals, the debtors are generally not notified of the assignment. The assignment thus remains "silent" vis-à-vis the debtors. As a result, the debtors continue to validly pay the claims to the assignor who must in turn pay to the assignee the collections received under the assigned claims on a daily, weekly or monthly basis, as applicable. This "silent" assignment enables the assignor to raise financing (by way of the assignment of claims) without affecting its commercial relationship with the debtors. It is only if and when the assignor becomes insolvent that the assignee will seek for the debtors to be notified of the assignment in order to receive payments directly. Therefore, due diligence to check the law that governs the claim is generally postponed to a later stage and is only carried out if the assignor becomes insolvent. An enforceability assessment will usually only be done in respect of the non-performing claims, that is, those under which the debtor stops payment.

In this context, it is therefore important that the law applicable to priority conflicts between the assignee and the creditors of the assignor coincides with the law applicable to the assignor's insolvency, thus facilitating interaction with the Insolvency Regulation<sup>84</sup>.

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<sup>81</sup> Ibid. p. 11.

<sup>82</sup> Goode, R., Response to the European Commission's public consultation, p. 6.

<sup>83</sup> Ibid. p. 6.

<sup>84</sup> Art. 2(9) of the Insolvency Regulation.

### ***Example of relation with the Insolvency Regulation***

*B is a trading company based in Germany which assigns to A, a factoring company based in the Netherlands, its claims against various customers throughout the EU. The factoring agreement and the contract of assignment are governed by Dutch law. After the assignment has been concluded, insolvency proceedings are opened over B's estate by a German court. On behalf of the insolvent estate, the administrator demands payment from the customers. A also demands payment. Article 8 EU Insolvency Regulation (recast) states that rights in rem of third parties are untouched by the main proceedings if those rights relate to tangible or intangible property that is situated outside the Member State in which proceedings are opened.*

Choosing the same approach as the Insolvency Regulation, which in Article 7(1) designates as the law applicable to a cross-border insolvency the law of the centre of main interest of the insolvent business (COMI), facilitates the solution of priority conflicts in cross-border cases. The application of the law of the assignor's habitual residence would lead to the application of a single law (COMI of the assignor) first to the preliminary question as to who the holder of the claim is and, second, to the possible avoidance or ineffectiveness of the transaction as between A and B as acts detrimental to the body of creditors<sup>85</sup>.

The conflict rule based on the assignor's habitual residence is also consistent with Article 22 of the 2001 UN Convention on the Assignment of Receivables in International Trade<sup>86</sup>. Although, for the time being, this UN Convention is not in force and Luxembourg is the only Member State which has signed it, alignment with the Convention rule would bring EU law in harmony with private international law in other States which would ratify this Convention in the future. Having a conflict of laws solution which is convergent with an international law instrument would also lead to a higher number of concrete converging cases in practice since jurisdictions of third countries would be more likely to accept the EU conflict of laws solution as compatible with an internationally accepted solution or with their national conflict of laws rules.

Consistency between the EU conflict rules applicable to the proprietary effects of assignments of claims and the EU conflict rules applicable to insolvency, and between the conflict rules applicable to the proprietary effects of assignments of claims in the EU and at international level, would make the determination of the applicable law more cost-efficient and lower transaction costs of the assignments of claims governed by different laws.

### **6.4.3 Impacts of Option 3: Law of the assigned claim**

#### **Effectiveness in reaching the objectives**

The law of the assigned claim can provide legal certainty as to the determination of the law applicable to the third-party effects of the assignment only if it is possible to ascertain which law governs the assigned claim. This can be facilitated if an express choice of law clause is

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<sup>85</sup> Art. 7(2)(m) of the Insolvency Regulation.

<sup>86</sup> <http://www.uncitral.org/pdf/english/texts/payments/receivables/ctc-assignment-convention-e.pdf>

included in the contract which includes the assigned claim. If the law of the assigned claim is known, it has the advantage of staying stable irrespective of a possible change of the assignor's habitual residence.

Conversely, the main drawback of choosing the law of the assigned claim as the law applicable to the third-party effects of the assignment is that third parties possibly affected by the assignment cannot know in advance which law governs their rights. Also, the application to the proprietary effects of the assignment of the law of the assigned claim would not be able to resolve priority conflicts in relation to assigned claims which have not been evidenced in writing. The law of the assigned claim would also not accommodate the common practice of assigning future claims, for which the applicable law is not determinable in advance as the transaction out of which the claim will arise has not yet been concluded<sup>87</sup>.

If the parties to an assignment transaction have their proprietary effects governed by the law of the assigned claim, they will need to check the contractual documentation concerning the claim in order to find out by which law such claim is governed. Since the enforcement of the claim against the debtor will always have to comply with the conditions laid down in the law which governs the claim, having the same law governing the enforceability of the claim and the third-party effects of the assignment will facilitate enforcement of the claim as no other conditions under another possibly applicable law would interfere.

### **Impacts on the parties concerned**

In connection with the assignment of trade receivables in the context of factoring, as the law of the assigned claim is usually the same as the law under which the claim is ultimately enforced, the application of the law governing the assigned claim to the third-party effects of the assignment could have a beneficial effect on assigning and enforcing an individual claim of a higher value. On the other hand, due to the prevalence of bulk assignments in factoring involving multiple claims, the law of the assigned claim would increase the costs of factoring transactions and, thus, have a negative effect on the development of factoring activities on a cross-border basis. In the same vein, the banking industry considers that the law of the assigned claim may lead to a restriction of opportunities for assignors, i.e. businesses and SMEs, to refinance their transactions.

As in the case of the law of the assignor's habitual residence, the securitisation industry is split as to the effects of applying the law of the assigned claim to the proprietary effects of securitisation transactions: some of the players who already use the law of the assigned claim as a connecting factor believe that the change of this connecting factor would adversely affect cross-border securitisation activities; in contrast, other players involved in the securitisation industry claim that the law of the assigned claim would render securitisation transactions more complex and would thus jeopardise their securitisation business.

### **Costs and coherence with existing EU acquis and the international solution**

Parties concerned by the proprietary effects of an assignment may want the assignment to be primarily safeguarded against a possible insolvency of the assignor, a creditor (of the assignor

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<sup>87</sup> Ibid., p. 3.

or the assignee) executing the receivable or a possible second assignment. One of the respondents to the public consultation explained that, "*if the governing law of the contract creating the debt, the governing law of the contract creating the assignment and the habitual residence of the debtor are of single jurisdiction, due diligence costs will be less than if different jurisdictions are involved, but it will always be necessary to check the issues that relate to the obligation of the debtor to recognise the assignment under the law of the underlying contract and, if different, the law of the habitual residence of the debtor. This is because the debt is the asset in respect of which the assignee is gaining rights and the assignee needs to know what it must do to obtain the repayment of the debt when it is made by the debtor.*"<sup>88</sup>

However, under the assigned claim's law approach, the choice of the law governing individual assigned claims would pose particular difficulties for insolvency administrators and the assignor's attachment creditors. Investigation of individual assigned contracts would be complex and expensive.

***Example of costs arising in assignments of claims governed by different laws***

*A debtor who has assigned a large volume of receivables arising under several contracts, some of which are governed by French law, some by English law, some by German law and some by Italian law, becomes insolvent. Is the insolvency administrator to be required to spend large sums of money investigating each of hundreds of contracts to find the applicable law and then further sums to obtain legal advice from lawyers in each of the four jurisdictions? This would generate unnecessary costs which would then have to be borne by the creditors, thus reducing their proceeds.*

The application of the law of the assigned claim to the proprietary effects of the assignment would be cumbersome in case of bulk assignments of claims presenting a cross-border element, such as trade receivables, which are the most common type of securitised assets for companies. In such cases, several laws would potentially govern the claims composing the assigned portfolio and, therefore, multiple local law opinions from local law firms would be needed to know the local formalities for the assignment of the claims to be enforceable against third parties<sup>89</sup>. The application of the law of the assigned claim would not achieve a cost reduction as each claim would have to be examined individually which, as shown by the following example, may render the assignment so costly that the transacting parties may prefer not to implement it.

***Example of costs of legal opinions on applicable laws in a cross-border assignment***

*A member of the expert group mentioned: "We are currently working on a cross-border trade receivables purchase programme for a big corporate group having an international business activity. This transaction involves assignors located in many jurisdictions including France*

<sup>88</sup> Feedback to the public consultation on conflict of laws rules for third party effects of transactions in securities and claims; available at: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>89</sup> Minutes of the Expert Group meeting 15-16 May 2017, available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail&groupID=3506>

*and Spain, with trade receivables held over debtors located in 47 different jurisdictions for the French assignor, and 31 jurisdictions for the Spanish assignor (with some jurisdictions in common but not all). Due diligence of the underlying contracts showed that some claims are governed by either French law, Swiss law, UK law or US law and that, for some others, there is no underlying contract signed between the parties so that there is legal uncertainty on the law applicable to these assigned claims. The costs of the legal memo to be obtained from local law firms on the formalities to be performed locally for the assignment of claims being enforceable against third parties (i.e. under the assumption that either the law of the debtor's location or the law of the assigned claim governed third-party effectiveness) were estimated to range between 5,000€ and 10,000€ per jurisdiction without taking into account the legal costs for coordination work on our side as transaction lawyers. Due to the number of the jurisdictions potentially involved for this local law analysis, we are now contemplating putting in place another financing structure not based on assignment of claims for claims presenting a cross-border element. This would probably increase the funding costs as the credit exposure will not be the same for lenders/investors.’’<sup>90</sup>*

The option of applying the law of the assigned claim to the third-party effects of an assignment would not be consistent with the international solution laid down in the 2001 UN Convention

#### **6.4.4 Impacts of Option 4: Mixed approach combining the law of the assignor's habitual residence with the law of the assigned claim**

##### **Effectiveness in reaching the objectives**

This mixed approach provides enhanced legal certainty by applying the most predictable law for third parties, that is, the law of the assignor's habitual residence, as a general rule and, at the same time, subjecting two specific situations to the law of the assigned claim as the law that responds to the expectations of market participants. This mixed approach also provides for flexibility in respect of the law applicable to the third-party effects of assignment of claims in the context of a securitisation by laying down the possibility for the assignor and the assignee to choose the law of the assigned claim. The possibility to choose the assigned claim aims at not hindering the current practice of large operators of applying this law to the third-party effects of the assignment of claims within a securitisation but, at the same time, at facilitating the entry or the strengthening of smaller operators in the cross-border securitisation market.

##### **Impacts on the parties concerned**

With regard to assignments subject to the general rule of the law of the assignor's habitual residence, the impacts of this option on third parties would not be different from the impacts on third parties described under Option 2.

As to the specific assignments subject, as an exception, to the law of the assigned claim, two situations must be distinguished. The first exception refers to the assignment by an account

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<sup>90</sup> Expert member quote from the discussion at the Expert Group meeting 15-16 May 2017.

holder of cash credited to an account in a credit institution. For third parties (creditors, competing assignees), greater predictability is provided if the law applicable to the third-party effects of such assignment is the law applicable to the assigned claim. The Expert Group maintained this view. This is because it is generally assumed that the claim that an account holder has over cash credited to an account in a credit institution is governed by the law of the country where the credit institution is located. This law is normally chosen in the account contract between the account holder and the credit institution<sup>91</sup>.

The second exception refers to assignments of claims arising from financial instruments such as derivative contracts. The third-party effects of these assignments should be governed by the law of the assigned claim and, therefore, by the law of the financial instrument itself. The Expert Group supported this view. Subjecting the third-party effects of assignments of claims arising from financial instruments to the law of the assigned claim rather than the law of the assignor's habitual residence is essential to preserve the stability and smooth functioning of financial markets as well as the expectations of market participants. These are preserved as the law that governs the financial instrument from which the claim arises, such as a derivative contract, is the law chosen by the parties or the law determined in accordance with non-discretionary rules applicable to financial markets.

The securitisation industry has expressed different needs with regard to the law applicable to the third-party effects of assignments of claims in the context of a securitisation. Large operators (the large banks) currently apply the law of the assigned claims to the third-party effects of assignments of claims within a securitisation and have stated that the new uniform conflict of laws rules should not interfere with this practice. For their part, smaller operators (smaller banks and corporates) have stated the need for the new rules to be based on the law of the assignor's habitual residence. The aim of this initiative is to promote cross-border investment and, therefore, the expansion of the market for cross-border securitisation. By laying down the possibility for the assignor and the assignee to choose the law of the assigned claim while, at the same time, maintaining the law of the assignor's habitual residence as the default rule, both large and smaller operators could decide, in view of the characteristics of each securitisation, which of the two laws is best suited to the transaction. By adapting to the needs of all operators, the flexibility of this option would promote cross-border investment and the expansion of the securitisation market to the largest extent.

### **Costs and coherence with existing EU acquis and the international solution**

To the extent that the majority of assignments of claims would remain subject to the general rule of the assignor's habitual residence, the analysis of the costs of implementing this mixed option would not differ from the assessment of costs explained under Option 2.

For the same reason, consistency of this mixed option with the Insolvency Regulation would only be marginally affected. In any event, the enhanced legal certainty provided by subjecting the assignment of cash credited to an account in a credit institution and of claims arising from financial instruments such as derivative contracts to the law of the assigned claim, as expected by market participants, would outweigh the benefits of consistency with the Insolvency

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<sup>91</sup> Minutes of the Expert Group meeting of 13-14 July 2017.

Regulation in the less frequent cases of insolvency of the assignor or assignee involved in these assignments.

The consistency of the law of the assignor's habitual residence, to which the vast majority of assignments of claims would be subject under this mixed option, with the international solution would not be affected, as the 2001 UN Convention on the Assignment of Receivables in International Trade excludes from its scope the assignment of receivables arising from bank deposits and financial contracts.

#### **6.4.5 Impacts of Option 5: Mixed approach combining the law of the assigned claim with the law of the assignor's habitual residence**

##### **Effectiveness in reaching the objectives**

As under Option 3, under the general rule in this mixed option the lack of predictability for the parties affected by the proprietary effects of a claim assignment as to which law will govern their interests would remain. The advantage of having to check only the law of the assigned claim to know the conditions for the enforceability of the claim against the debtor and against third parties would also apply under this mixed option.

The greater legal certainty provided by the law of the assignor's habitual residence would only apply, as an exception, to the assignment of multiple and future claims.

##### **Impacts on the parties concerned**

The rationale of the exception to the general rule under this mixed option is the need to consider the requirements of the factoring and the securitisation industries. The application of the law of the assignor's habitual residence instead of the law of the assigned claim to the assignment of multiple and future claims would address the difficulties that market participants involved in factoring and securitisation would face if they had to check the law governing multiple claims in a bulk assignment or know the law governing claims not yet constituted, often also included in a bulk assignment.

##### **Costs and coherence with existing EU acquis and the international solution**

The legal costs for factoring and securitisation operators of having to check and comply with the requirements under the laws governing multiple claims in a bulk assignment may significantly increase the costs of a cross-border assignment and even lead parties to abandon the transaction. The exception to the general rule under this mixed option would address these concerns by applying the law of the assignor's habitual residence to the assignment of multiple claims.

The solution under this mixed option would only partially be consistent with the conflict of laws rules of the Insolvency Regulation and the solution chosen at international level by the 2001 UN Convention on the Assignment of Receivables in International Trade. Only cases where multiple claims are assigned, subject to the rule of the law of the assignor's habitual residence, would benefit from synergies with other EU and international solutions.

## 6.5 Issues raised by stakeholders

With regard to the **law applicable to the assignment contract**, some stakeholders considered that this law would provide clarity and be consistent with Article 14(1) of the Rome I Regulation, which provides that this law applies to the relationship between the assignor and the assignee.

With regard to the application of the **law of the assignor's habitual residence** as a rule, stakeholders considered that this law could be determined easily and would thus provide great legal certainty, and that it would respect more than any other approach the economic logic of important trade practices. Stakeholders also positively highlighted the consistency of this rule with the Insolvency Regulation and the 2001 UN Convention on the Assignment of Receivables in International Trade.

As a negative aspect, stakeholders noted that the law of the assignor's habitual residence would require looking at a third conflict rule applicable to the assignment, as the Rome I Regulation (Article 14) already lays down the rule of the assignment contract applicable between the assignor and the assignee and the law of the assigned claim applicable between the assignor and the debtor. This law may be more cumbersome if the claim is assigned several times (as the habitual residence of various assignors would need to be ascertained). Some stakeholders also argued that the use of location-based tests in modern conflict of laws rules is inappropriate as this connecting factor is subject to changes, may be hard to define when the 'nationality' of a company differs from that of its branches and is merely a question of fact.

On the specific issue of the assignment of **cash held in accounts**, the majority of respondents expressed a preference for the law governing the assigned claim (7 respondents) or for the law of the place where the cash account is located (4 respondents). Only a minority expressed a preference for the law of the assignor's habitual residence.

With regard to the assignment of **cash as collateral** and the assignment of **credit claims as collateral**, stakeholders mostly preferred the law governing the assigned claims<sup>92</sup>.

On the specific issue of the assignment of **claims used as underlying assets in securitisation**, the law governing the assigned claim and the law applicable to the assignment contract were favoured by 4 respondents respectively, whereas the law of the assignor's habitual residence was preferred by 2 respondents.

As to the application of the **law governing the assigned claim** as a rule, stakeholders noted that this law would comply with the principle of party autonomy, would guarantee consistent outcomes as between competing assignments of the same claim and potentially lower transaction costs, as due diligence with regard to the law applicable to the underlying debt (that is, the assigned claim) must be carried out in any event in most cases.

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<sup>92</sup> Cash collateral: 5 respondents, compared to 3 respondents preferring the assignor's habitual residence; 2 preferred the law of the contract between assignor and assignee, 1 the law of the security settlement system; Credit claims: 4 respondents, compared to 3 respondents preferring the assignor's habitual residence; 1 preferred the law applicable to the assignment contract, 1 the law of the country where collateral is located.

However, stakeholders expressed strong concerns with this law applying to **claims under future contracts and to bulk assignments of claims**. In the first case, because the claim does not yet exist. In the case of bulk assignments, as it may be unfeasible for the assignee to establish which law applies to each claim/receivable if each claim is subject to a different law. Most of the stakeholders feared that, due to the predominance of bulk assignments in factoring, the application of such law would lead to a significant decrease in cross-border factoring transactions.

## **6.6 How do the options compare?**

The options will be hereafter compared against each other as to stakeholder preferences, their effectiveness, their impact on the parties concerned, their cost and their consistency with EU *acquis* and the international solution.

Compared to the baseline scenario, the adoption of a uniform solution at EU level, irrespective of the option chosen, would improve the current situation of legal uncertainty. At least, the parties concerned by the proprietary effects of a claim assignment would know the connecting factor that would designate the national law applicable to their interests.

### **6.6.1 Stakeholder preferences**

Stakeholders were asked about their preferences as to the law that should apply to the proprietary effects of cross-border transactions in claims in the study contracted by the Commission and also in the public consultation.

In the study contracted by the Commission, 44% of the stakeholders consulted favoured the law of the assignor's habitual residence and 30% favoured the law of the assigned claim. The least favoured option by the stakeholders was the law applicable to the assignment contract (11%)<sup>93</sup>.

In the public consultation, stakeholders were asked to indicate their preferences as to the law that should be chosen in a Union legislative initiative in three separate sub-questions. Out of the stakeholders that responded to each of the three separate questions, 57% of stakeholders favoured the law of the assignor's habitual residence, 43% favoured the law of the assigned claim and 30% preferred the law of the assignment contract<sup>94</sup>.

The Expert Group on conflicts of laws considered that the law applicable to the assignment contract between the assignor and the assignee was not suitable to govern the third-party effects of transactions in claims.

A dedicated informal meeting with Member States in the framework of the public consultation revealed a preference of one Member State for the law of the contract between the assignor and the assignee as the applicable law to the third-party effects of claim assignments. Representatives of three other Member States expressed their preference for the law of the assigned claim while representatives of three other Member States favoured the law

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<sup>93</sup> BIICL Study (2012), p. 15.

<sup>94</sup> Statistical summary of responses to public consultation, question 26.

of the assignor's habitual residence. A number of Member States expressed flexibility as to the law to be chosen.<sup>95</sup>

### **6.6.2 Effectiveness comparison**

Knowing that the connecting factor that would designate the applicable law is either the law of the assignment contract, the law of the assignor's habitual residence or the law of the assigned claim, parties would then need to ascertain which country's that law is. In this connection, parties would benefit from the most predictable and transparent connecting factor.

Only the law of the assignor's habitual residence can be ascertained in advance by the parties concerned by the proprietary effects of the claim assignment. The law of the assignment contract and the law of the assigned claim are in principle only known by the parties to the assignment contract (the assignor and the assignee) and the parties to the assigned claim (the original creditor/assignor and the debtor).

The law of the assignor's location allows the parties to the assignment to know, before the assignment takes place, which country's law lays down the requirements that need to be fulfilled to ensure the acquisition of legal title over the claim (for example, notification to the debtor or registration of the assignment). It also enables third parties such as creditors and competing assignees to know which country's law would apply to resolve a possible dispute.

In contrast, the application of the law of the assignment contract or the law of the assigned claim would require a preliminary step from the parties concerned, namely to first find out which law was chosen by the assignor and the assignee to govern their assignment contract (or which law is designated by the statutory rules in the absence of choice), or which law was chosen by the original creditor/assignor and the debtor to govern their claim (or which law is designated by the statutory rules in the absence of choice<sup>96</sup>).

By providing predictability and thus greater legal certainty, the law of the assignor's habitual residence is superior to the law of the assignment contract and the law of the assigned claim. Predictability in all or some assignment cases would only be provided under the options based fully (Option 2) or partially (Options 4 and 5) on the law of the assignor's habitual residence.

In contrast with the law of the assigned claim, both the law of the assignment contract and the law of the assignor's habitual residence can apply to future claims.

### **6.6.3 Comparison of impacts on the parties concerned**

The interests of the third parties concerned by the claim assignment, namely the creditors of the assignor or the assignee and possible competing assignees, are least protected by the law of the assignment contract, which is chosen by the assignor and the assignee to fit their assignment transaction.

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<sup>95</sup> Informal meeting with Member State experts on conflict of laws rules of 18 September 2017.

<sup>96</sup> In the EU, Article 4 of the Rome I Regulation would be applicable in most cases.

With regard to the assignee, both the law of the assignment contract and the law of the assignor's habitual residence can in principle apply in the factoring and securitisation industries as the assignee would only need to look at and comply with the requirements under one law to acquire legal title over the claims. In contrast, the application of the law of the assigned claim in these industries would be impracticable as the laws governing the claims assigned in bulk, most often of different countries, and the requirements under all such laws would need to be examined and respected.

The application of the law of the assigned claim would respect the market practice of applying the law of the assigned claim to the assignment of cash credited to an account in a credit institution and to claims arising from financial instruments such as derivative contracts. This would only be achieved under the options based fully (Option 3) or partially (Options 4 and 5) on the law of the assigned claim.

Flexibility as to the law applicable to the third-party effects of assignments of claims in a securitisation to maintain the current market practice of large operators and, at the same time, promote cross-border investment by expanding the securitisation market to smaller operators would only be achieved under Option 4.

#### **6.6.4 Cost and coherence comparison**

Given that, pursuant to the Rome I Regulation, the law of the assignment contract applies to the relationship between the assignor and the assignee, and the law of the assigned claim applies to the relationship between the original creditor/assignor and the debtor, choosing one of these two laws (instead of a third law such as the law of the assignor's habitual residence) as the law applicable to the third-party effects of the assignment would create synergies and thereby reduce costs.

In the case of bulk assignments of claims and assignments of future claims, both typical of the factoring and securitisation industries, the law of the assigned claim leads to high legal costs or cannot be applied if the claim does not yet exist. Both the law of the assignment contract and the law of the assignor's habitual residence allow such assignments at a reasonable cost as the assignee only needs to look at one law to know the formalities he needs to complete to acquire legal title over the claims.

As to the overall cost-benefit impact of EU action to harmonise the conflict of laws rules applicable to the third-party effects of claim assignments, the introduction of a uniform solution will generate one-off costs for transacting parties to check and possibly adapt the legal documentation they currently use. The one-off costs of revision and adaptation of legal documentation will only be borne by transacting parties who currently apply to their assignment a law different from the law chosen by the initiative.

These one-off costs must be compared to the much greater and continued costs incurred under the baseline scenario, where market participants may incur financial losses if they are unaware of the legal risk posed by the current legal uncertainty; must incur legal costs for researching and/or complying with the requirements of all potentially applicable laws if they want to mitigate the legal risk; or miss profitable business opportunities if they are deterred by the legal risk.

Consistency between the law applicable to the third-party effects of claim assignments and the law applicable to the insolvency of the assignor or the assignee would greatly facilitate the resolution of competing demands over the same claim, as it is in the context of insolvency that it needs to be determined who has legal title over a claim so as to determine the insolvency estate. As the Insolvency Regulation bases its conflict of laws rule on the centre of main interest of the insolvent business (COMI), consistency in all or some assignment cases would only be achieved under the options based fully (Option 2) or partially (Options 4 and 5) on the law of the assignor's habitual residence.

Given that large bulk assignments of claims often include claims governed by the laws of third countries, consistency between the EU solution and the solution adopted at international level by the 2001 UN Convention on the Assignment of Receivables in International Trade would facilitate the resolution of international disputes, lower transaction costs and increase the volume of international assignments. As the UN Convention bases its conflict of laws rule on the assignor's habitual residence, consistency in all or some assignment cases would only be achieved under the options based fully (Option 2) or partially (Options 4 and 5) on the law of the assignor's habitual residence.

The adoption by the EU and the UN Convention of the same approach would enable the EU and the Member States to adopt the Convention if they deemed it appropriate. Even without such adoption, alignment with the UN Convention rule, whose substance is already accepted in several States, would bring EU law in harmony with the conflict of laws rules applicable in other parts of the world.

To the extent that an assignor has his habitual residence in the EU, the law of the assignor's habitual residence is the only law that could promote the application of the substantive law of Member States and reduce the scope for forum shopping.

The application of the law of the assignor's habitual residence to the third-party effects of assignments of claims as a general rule, combined with the application of the law of the assigned claim to the third-party effects of certain assignments of claims (that is, cash, claims arising from financial instruments and assignments of claims in certain securitisation structures) is the most cost-effective option as it provides legal certainty whilst adapting best to existing market practice and the needs of operators.

#### **6.6.5 Overall comparison**

In view of the above analysis, a comparison of the options on the law applicable to the third-party effects of assignments of claims can be summarised as follows:

LAW APPLICABLE TO THE THIRD-PARTY EFFECTS OF THE ASSIGNMENT OF CLAIMS	<u>Effectiveness in reaching the objectives</u>	<u>Impacts on the parties concerned</u>	<u>Costs and coherence with EU acquis and the UN international solution</u>
Baseline scenario	0	0	0
<b>Option 1 – Law of the assignment contract</b>	<p>No predictability for third parties</p> <p>Permits assignment of future claims</p> <p>0/+</p>	<p>Does not take into account the interests of third parties (creditors and competing assignees)</p> <p>Applicable in the factoring and securitisation industries</p> <p>0/+</p>	<p>Synergies if the law of the assignment contract is chosen to be the same law as the law of the assigned claim</p> <p>No coherence with EU acquis or the UN international solution</p> <p>0/+</p>
<b>Option 2 – Law of the assignor's habitual residence</b>	<p>Predictable for third parties</p> <p>Permits assignment of future claims</p> <p>+++</p>	<p>Optimal for the factoring industry; convenient for part of the securitisation industry</p> <p>Does not take into account market practice in specific situations (cash and claims arising from financial instruments)</p> <p>+</p>	<p>Higher costs in assignments of a single claim, but lower costs in assignments of multiple claims</p> <p>Coherence with EU acquis</p> <p>Coherence with the UN international solution</p> <p>++</p>

<p><b>Option 3 – Law of the assigned claim</b></p>	<p>No predictability for third parties</p> <p>Does not permit assignment of future claims</p> <p>0</p>	<p>Not viable for the factoring industry</p> <p>Inconvenient for part of the securitisation industry</p> <p>Takes into account market practice in specific situations (cash and claims arising from financial instruments)</p> <p>+</p>	<p>Synergies as the law applicable to third parties is the same as the law applicable to the assigned claim (the debtor)</p> <p>Significant/prohibitive legal due diligence costs in assignments of multiple claims</p> <p>No coherence with EU acquis</p> <p>No coherence with the UN international solution</p> <p>0/+</p>
<p><b>Option 4 – Mixed approach: assignor's law (rule) and law of the assigned claim (exception)</b></p>	<p>Rule:</p> <ul style="list-style-type: none"> <li>- Predictable for third parties</li> <li>- Permits assignment of future claims</li> </ul> <p>+++</p>	<p>Rule: Optimal for the factoring industry; convenient for part of the securitisation industry</p> <p>Exception: Takes into account market practice in specific situations (cash and claims arising from financial instruments)</p> <p>Choice of law: Takes into account market practice for part of the securitisation industry</p> <p>+++</p>	<p>Coherence with EU acquis</p> <p>Coherence with the UN international solution</p> <p>+++</p>
<p><b>Option 5 – Mixed approach: law of the assigned claim (rule) and assignor's law (exception)</b></p>	<p>Partial predictability for third parties (only in cases covered by the exception)</p> <p>Partially permits assignment of future claims (only in cases covered by the exception)</p> <p>++</p>	<p>Rule: Takes into account market practice in specific situations (cash and claims arising from financial instruments)</p> <p>Exception: Takes into account the needs of the factoring and securitisation industries</p> <p>+++</p>	<p>Partial coherence with EU acquis (only in cases covered by the exception)</p> <p>Partial coherence with the UN international solution (only in cases covered by the exception)</p> <p>++</p>

The law of the assignor's habitual residence has a number of benefits: it is the only law that can be predicted and easily found by the parties concerned by the assignment; it responds to the needs of factors and small securitisers, assignees not equipped to investigate individual contracts, assignees of future claims and the creditors of the assignor. It can facilitate the resolution of priority conflicts in situations of insolvency of the assignor or the assignee because it is consistent with the connecting factor used in the Insolvency Regulation. It can also create synergies and thereby save legal due diligence and litigation costs for market participants who operate on a global basis due to its compatibility with the 2001 UN Convention on the Assignment of Receivables in International Trade. In addition, even when, currently, the parties choose to apply the law of the assigned claim to the third-party effects of their cross-border assignment, most of the times they also look at the law of the assignor's habitual residence to make sure that the acquisition of legal title over the claims assigned will not be prevented by overriding mandatory rules of the country of the assignor's habitual residence, in particular the rules laying down publicity requirements such as the obligation to register the assignment of claims in a public register to make it known to third parties<sup>97</sup>.

A solution combining a general rule based on the law of the assignor's habitual residence, an exception based on the law of the assigned claim to apply to certain assignments (of cash credited to an account in a credit institution and of claims arising from financial instruments such as derivative contracts) typically subject to the law of the assigned claim, and a choice of law possibility to accommodate for a large part of the securitisation industry would accommodate the needs of market participants to the greatest extent.

The preferred option is therefore Option 4.

#### **6.6.6 Legal form of intervention**

The preferred option would be embodied in a Regulation. The desired uniformity of the conflict of laws rules can only be achieved through a Regulation as only a Regulation ensures a consistent interpretation and application of the rules. A Directive would leave room for differences in the transposition of the rules into national law as well as for their interpretation and application. In line with previous EU instruments on conflict of laws rules, the preferred legal instrument is thus a Regulation.

### **7 BOOK-ENTRY SECURITIES: OPTIONS, IMPACTS AND WHO WILL BE AFFECTED**

#### **7.1 Screening of options: non-legislative and legislative solutions**

A screening of options reveals that there are both legislative and non-legislative alternatives.

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<sup>97</sup> For example, the German Banking Industry Committee (which advocates the assignor's law) states in its response to the public consultation that, in securitisation transactions, parties need to check notice or registration requirements. The Association for Financial Markets in Europe (AFME) states in its response that parties must check whether the assignment will be effective under the law of the assignor.

Three non-legislative measures could be envisaged: 1. informing stakeholders to the extent possible and where appropriate about the legal uncertainty; 2. providing standardised legal opinions for standard transactions; and 3. improving the transparency of the existing Union conflict of laws rules wherever possible.

The first non-legislative measure would not solve the residual problem in itself, as it would result in one of the other two possible responses referred to in the problem tree: market participants can either mitigate legal uncertainty, incurring additional costs, or they can refrain from entering into the transaction. Neither outcome would be optimal.

The second non-legislative measure would seem to offer at least a partial solution. However industry associations as well as individual market participants are already commissioning standardised legal opinions whenever possible to save on legal costs. It is unlikely that non-legislative EU intervention could go beyond what the industry has already been doing in terms of cost reduction. Also, for transactions that are not sufficiently standardised it is not cost efficient, and often not even feasible, to produce standard legal opinions. Therefore this measure would not be effective at addressing the problem that some transactions might not take place due to the unclear legal situation and the risks this implies. A few examples where this might be the case include: (i) those transactions that are not standard and recurrent, (ii) those transactions that can be structured in a way such as to get around the risks imposed by legal uncertainty, as well as (iii) those transactions for which it is a requirement that not more than two laws are applicable to the transaction.

The third non-legislative measure would require issuing a Communication to clarify the Commission views of the three existing EU Directives. This measure could remedy the problem, namely divergent national interpretations. Therefore this option will be further analysed for its impacts.

Legislative options could also be envisaged. These could take different forms and have different content. As for their form, they could be either an amendment of the conflict of laws rules of the existing three directives or repealing the specific provisions of the Directives and proposing a Regulation with new conflict of laws rules. As for their content, they could follow i) the choice of law solution as per the Hague Securities Convention, ii) the current EU acquis, or iii) a compromise solution that introduces scope for choice of law within the current EU acquis. Legislative solutions could also address the problem of different national interpretations of the existing rules, and will therefore also be retained for further analysis.

## **7.2 Descriptions of options retained for analysis**

The three retained options on content that will be analysed are therefore (1) the choice of law option in line with the Hague Securities Convention, (2) the "place of relevant intermediary approach" (PRIMA) in line with the existing EU acquis, and (3) a legislative mixed approach between the existing EU acquis and The Hague Securities Convention.

The two possible forms of EU intervention would be either legislative (an amending directive or a regulation replacing the relevant conflict of laws provisions) or non-legislative (a Communication).

### **Legislative options:**

- 1) **Choice of law:** Law governing the account agreement as expressly agreed by the contracting parties, if the intermediary has an office in that state (possibly through ratification of the [Hague Securities Convention](#));
- 2) **PRIMA, where the account was opened:** Law of the intermediary or branch where account was opened for the client (through amending Directive or a new Regulation);
- 3) **PRIMA, where the account is maintained:** Law of the intermediary or branch where account is maintained.<sup>98</sup> The account agreement shall specify the intermediary or branch maintaining the account through the legal entity identifier (LEI) (through amending Directive or a new Regulation).

#### **Non-legislative options:**

- 4) **Communication improving clarity in the existing EU acquis:** A Communication improving clarity in the existing EU acquis, expressing the Commission's on rules.

### **7.2.1 Baseline: no EU intervention**

The baseline scenario, against which all options are measured, consists of no action (be it legislative or non-legislative) at EU level. The baseline leaves it fully to Member States and markets to address the issue of different interpretations without any further guidance at European level.

### **7.2.2 Option 1: Choice of law**

Option 2 would put in place rules that follow the choice of law solution of the Hague Securities Convention.

This option could take the form of proposing the ratification of the Convention itself, or, if specific legal issues need to be addressed, this option could take the form of a Regulation that lays down rules that follow closely the rules of the Convention. It is not feasible to achieve this option through a non-legislative option such as an interpretation of the existing Directives.

### **7.2.3 Option 2: PRIMA – where the account was opened**

PRIMA exists in EU law, but as Annex 2 shows, it is given different interpretations in different Member States and it is therefore not applied in a uniform way across all Member States. This option proposes to define what is meant by PRIMA, designating as governing law **the law of the state of the intermediary or branch that opened the account for the client.**

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<sup>98</sup> Maintaining the account would be defined as effecting or monitoring entries into securities accounts, administering payments or corporate actions or other regular activity necessary for administration of securities accounts. This definition is in line with the Hague Securities Convention's fall-back option, which determines the applicable law in cases where there was no valid choice of law in the account agreement.

This option could take the form of a Regulation, an amending Directive, or a Communication. Each of these tools could clarify the concepts of the existing Directives that are subject to interpretation.

#### 7.2.4 Option 3: PRIMA – where the account is maintained

This option was put forward by the Expert Group<sup>99</sup> as an alternative solution to address the problem through a clarified PRIMA concept. This option designates as governing law the **law of the state of the intermediary or branch that maintains the securities account**.<sup>100</sup>

This option could take the form of a Regulation, an amending Directive, or a Communication could also clarify those concepts of the existing Directives that are subject to interpretation.

### 7.3 Analysis of impacts

The options will be analysed as for their effectiveness in reaching the objectives of reducing costs and reducing losses. Improving legal certainty is the specific objective, and ensuring clear rules and their consistent implementation is the operational objective. To have the same substantive law applicable irrespective of where the competent authority or court examines a case within the EU achieves legal certainty.

The options will also be analysed as to their cost of implementation. This consists of the cost incurred by the state, the courts, the transacting parties and third parties in applying the rule of a given option instead of the currently applicable rules (baseline scenario).

Considerations also take into account the specific issues raised by stakeholders during the consultation process. These are the following:

#### **Impacts on all stakeholders:**

Would the rules deviate from **existing EU acquis**?

Would the rules lead to the **applicability of non-EU law**?

Would the rules be **technology proof**?

#### **Impact on Member States:**

Would the rules lead to any **negative fiscal impacts**?

#### **Impact on account holders:**

Does the **account holder** have an influence on, and understanding of, the applicable law?

#### **Impact on third parties:**

How easily can **third parties** and issuers identify the applicable law?

#### **Impact on global players:**

Are rules consistent with the rules of non-EU countries?

#### **Impact on CSDs:**

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<sup>99</sup> Expert group on conflict of laws regarding securities and claims:

<http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3506>

<sup>100</sup> The term "maintaining an account" would be defined similarly to the Hague Convention through a sequential test: effecting or monitoring entries into securities accounts, administering payments or corporate actions or other regular activity necessary for administration of securities accounts.

How would the rules impact the business models of **central securities depositories (CSDs)** and custodians?

### 7.3.1 Baseline

#### **Effectiveness in reaching the objectives:**

To recall, the objectives of any intervention on securities are to reduce any residual costs of cross-border transactions and to reduce any unexpected losses. Given the existence of EU legislation on the most relevant aspects, the issues that remain were found not to be substantial problems. In line with this, any objectives to improve are marginal improvements. Given that cross-border activity is already quite substantial, increasing cross-border transactions is not an explicit objective.

	<b>Problems</b>	<b>Objectives</b>	
<i>Driver</i>	Unclear and differently implemented rules	Ensure clear rules and consistent implementation	<i>Operational</i>
<i>Problem</i>	Legal risks	Improve legal certainty	<i>Specific</i>
<i>Consequences</i>	Costs Losses	Reduce costs Reduce losses	<i>General</i>
<i>Size or scale of problems</i>	Residual	Marginal	<i>Size or scale of expected improvements</i>

In the absence of any EU intervention it is unlikely that Member States would arrive to a common interpretation of the three relevant directives and apply the rules in a more uniform way than at present. Markets would continue to work with the existing rules as they currently do, finding solutions with legal opinions and structuring transactions according to the national interpretations of EU conflict of laws rules.

### 7.3.2 Impacts of Option 1: Choice of law

#### **Effectiveness in reaching the objectives**

Introducing rules that allow for choice of governing law to the contracting parties (the account holder and the account provider), following the solution of The Hague Securities Convention, would make rules clearer to contracting parties. Therefore it could theoretically reduce their costs (costs related to assessing the applicability of different national laws) and any potential unexpected losses (losses that result from the unforeseen applicability of different national laws). Exact figures are not available to quantify these costs and losses, but as the problem definition already pointed out, these do not appear to be material problems for the industry.

#### **Impacts on stakeholder groups**

Account holders: End investors as account holders might find that the intermediary with market power imposes the applicable law, without end investors having a real say.

Third parties: marginal additional costs of discovering applicable law from the account agreement. There is a cost impact, but it is not substantial compared to the overall cost of establishing an interest in securities, and compared to how easy or hard it is currently to establish which law applies. Third parties that are not collateral takers but creditors would also have to run additional costs of obtaining the information from the account agreement as to the applicable law. Finally issuers would also find it cumbersome to look into the account agreement for the choice of law clause in order to identify which law applies to ownership.

Applicability of non-EU law: broad possibility to choose non-EU law. Since parties are free to choose as governing law the law of any state where the intermediary has an office, non-EU laws could be designated as applicable law in any circumstances, as long as the intermediary providing the accounts has an office in the state the law of which is chosen. The issue of international consistency of conflict of laws provisions is an important consideration for a large number of European market participants. It would offer cost saving to market players with an international portfolio of securities or those engaging with international counterparties. In the public consultation this aspect was mentioned by respondents (private parties as well as public bodies) as an important consideration.<sup>101</sup>

### **Costs and coherence with existing EU acquis**

Coherence with EU acquis: The adoption of the Hague Securities Convention would require changing the existing EU law provisions in the existing EU acquis under the SFD, FCD and WUD, to introduce rules in line the latter, or, alternatively to withdraw the relevant provisions of the three Directives and ratify the Hague Securities Convention. The lack of political support from a number of Member States, as well as the doubts of the European Parliament and the ECB was the sharp contrast between the approach of the EU acquis (place of the relevant intermediary approach - PRIMA) and the approach of the Hague Securities Convention (choice of law).

Costs: In their response to the public consultation CSDs pointed out that they expect that an overarching reform which deviates from the currently applicable conflict of laws rules would result in a review of legal opinions covering the conflict of laws questions.<sup>102</sup> They did not quantify the costs of such reviews. However they point out that a conflict of laws rule referring to the law governing the contract would, for accounts in some CSDs, have to be associated with the law applicable to the securities settlement system or the law of the CSD to cater for the fact that those CSDs do not have a direct account agreement with the account holders/investors. Without an appropriate safeguard, the CSD could find itself with deposits

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<sup>101</sup> Respondent arguing that a bank does not know if creditors of a customer will try to reach the securities by using judicial process in a state inside or outside the EU. Anonymous response.

"If - for whatever reason - the European Union decides not to sign the Hague Securities Convention, the conflict of laws rules of the Hague Securities Convention (Art. 4) are worth being considered for a European approach. European law along the lines of the rules of the Hague Securities Convention would ensure that European markets do not deviate from the global standard even if the European Union has not ratified the international Hague Securities Convention."

<sup>102</sup> See the response of ECSDA to the public consultation.

governed by a multitude of laws chosen by account operators and, as a result, a multitude of laws governing proprietary aspects of securities deposited with it.<sup>103</sup>

### **7.3.3 Impacts of Option 2: PRIMA – where the account is opened**

#### **Effectiveness in reaching the objectives**

Option 2 would deliver on simplification and consistency within the EU: it would ensure that no matter where the legal proceeding is started or which authority examines the case *within the EU*, always the same law will be applicable. However this option is not effective in achieving the objective of international consistency. Under option 2, depending on whether the case is brought to competent court or authority (inside or outside the EU), potentially different laws will apply to determine proprietary rights in securities. Legal uncertainty would thus remain in an international context.

The main drawback of this option is that it cannot offer international consistency and therefore some legal uncertainty and additional costs will remain for those market participants that are active internationally.

#### **Impacts stakeholders**

The PRIMA option would not offer a choice of law to contracting parties as did sub-option 1, and therefore there would not be any impacts related to choice of non-EU law. Applicability of non-EU law would be limited to situations where the account is opened outside the EU.

#### **Costs and coherence with existing EU acquis**

Coherence: This option would also be consistent with the existing EU acquis. The laws of Member States currently apply PRIMA based on the EU Directives and in some cases also beyond the scope of those Directives. However the interpretation of relevant intermediary differs across Member States. Under this option even if Member States currently apply some interpretation of PRIMA, they might have to change their law or their legal practice in order to adopt the new uniform EU definition of this concept: where the account was opened for the client.

Costs: Changing the law would entail costs, not only for the legislative changes but also for the courts deciding cases, and the market participants when preparing legal opinions for their transactions.

### **7.3.4 Impacts of Option 3: PRIMA – where the account is maintained**

#### **Effectiveness in reaching the objectives**

The mixed approach was developed by the Legal Expert Group to find a way to address the shortcomings of both above examined options. This option has the advantage of option 2 of

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<sup>103</sup> See the response of Euroclear to the public consultation.

not allowing free choice of law that might prejudice end investors and third parties. It would also be relatively close to the current legal solutions applied in member states. It would achieve the objective of EU-wide consistency in the same way as option 2 would. In addition it would also allow market participants to obtain international consistency in some specific situations: when the law chosen under the Hague Securities Convention in a third country coincides with the law of the state where the account is maintained, and when there is no valid choice made in the third country applying the Hague Securities Convention. Arguably the latter objective, international consistency, would not be achieved to the same extent as under option 1, choice of law. But option 3 would allow somewhat more opportunity for an internationally consistent solution than option 2, by enabling internationally active players to comply with both the EU solution and the Hague Securities Convention that applies in the US and Switzerland.

### **Impacts on stakeholders**

Solutions such as the use of the legal entity identifier (LEI) in the account agreement to specify the entity maintaining the account would ensure that third parties can get access more easily to the relevant information on governing law than under option 1, choice of law. Using the LEI facilitates obtaining precise, non-confidential information from the account agreement. It would still come at additional costs to third parties, but arguably lower costs than under option 1.

Account holders would have more clarity over the governing law than under the current situation where conflict of laws rules are inconsistent. The legal definition of where the account is maintained would give more reassurance to the weaker contracting party (account holders, including also end-investors) than option 1, choice of law, that the governing law will not be arbitrarily imposed by the account provider. A requirement that the law where the account is maintained be explicitly mentioned also in the account agreement would provide further clarity to account holders. However intermediaries have some leeway to define where an account would be maintained, which means that account holders, especially end investors would not be protected as much as under option 2, and might be exposed to a provision on place of maintenance and governing law that they do not expect.

This option limits the applicability of non-EU law to those situations where the account is maintained outside the EU.

### **Costs and coherence with existing EU acquis**

Coherence: Under this option a number of transactions would be internationally consistent: those where the law chosen in the account agreement coincide with the law of the state where the account is maintained by the intermediary or the branch, as well as those where no valid choice has been made (given that the fall-back option of the Hague Securities Convention would apply the same rule as this option). Other situations however would not be 'internationally consistent': if parties choose a governing law other than the law of the state where the account is maintained. In these cases questions of ownership in the same securities might be judged under a different law for example in the US than in the EU.

Costs: The costs of compliance with this option are likely not to be excessive, given that it stays close to the current wording of the Financial Collateral Directive (the law of the state

where the account is maintained) but defines this concept more clearly to avoid differing national interpretations.

## **7.4 How do the legislative options compare?**

This section compares the options on applicable law as well as the different options on the relevant level(s) of accounts. To facilitate the comparison, the options on governing law and relevant level of account were combined in a way to get realistic and workable options that aim to maximise benefits.

### **7.4.1 Stakeholder preferences**

#### **Value added in EU action**

The public consultation that took place between April and July 2017 asked whether stakeholders saw **value added in EU action to harmonise applicable conflict of laws rules** in this field. To this question, 19 respondents answered positively, i.e. they see added value in EU action, and 9 respondents thought EU action would not have added value. Overall it appears that there is no unanimous support for EU action, although about two thirds of the respondents would favour intervention.

#### **Form and scope of intervention**

When asked about the **form and scope of intervention**, 11 stakeholders were of the opinion that targeted amendments to existing EU legislation (SFD, FCD and WUD) would be sufficient, among them some of those who argued no intervention is needed (6 respondents). 9 respondents favoured an overarching reform, i.e. a separate legal act that would specify the applicable law to third party effects of transactions in securities. In addition, 7 respondents thought that both solutions – targeted amendments or an overarching reform – could be effective. Therefore, when asked about a legislative intervention, slightly more stakeholders were in favour of an amendment of existing Directives than an overarching new initiative.

#### **Governing law**

The public consultation tested options on the **governing law**. 7 respondents expressed preference for the choice of law option, and 9 preferred a definition of the applicable law based on PRIMA (of which 2 respondents would leave it to parties to define contractually the relevant intermediary). Of those respondents who see no added value in EU action, 6 replied that they would prefer PRIMA, should policymakers decide to put forward a legislative proposal.

In several responses the reason provided for the choice of PRIMA as the preferred option was that respondents were aware that adopting the Hague Securities Convention - which would otherwise be their own preferred option - was politically not feasible, due to resistance from other stakeholders. These respondents stressed however that the definition of PRIMA should be as close as possible to the definitions used under the Hague Securities Convention. At the same time there were also respondents preferring PRIMA due to a fear of "major legal uncertainty in a complete overhaul in the paradigm of the current conflict of law rules". Two stakeholders preferred the issuer's law and 6 other proposals were made that were mainly

variants of PRIMA and Hague, for example the place of the relevant account approach, a limited right to parties to choose the applicable law, etc.

On preferences of stakeholders between options 2.) and 3.) on how to define PRIMA, out of the 15 stakeholders opting for PRIMA only 8 gave their preference. 6 respondents thought that PRIMA should be defined through the intermediary's branch handling the account, 1 argued for the intermediary's registered office, another one proposed a list of three criteria to be taken into account: the state in which the representative office of the intermediary is, the state in which the intermediary's head office is and the state in which the intermediary's branch is maintaining the account.

As a result, stakeholders are strongly divided between the choice of law option and PRIMA, where most respondents did not clarify how PRIMA should be interpreted exactly, but the intermediary's branch handling the account got the highest support.

### **Costs and benefits**

Neither part of the consultation strategy (explained in detail in Annex 2) could deliver any cost estimates or quantified benefit assessments. Therefore a comprehensive and quantitative cost benefit analysis on the options on book-entry securities is not possible. The options on book-entry securities as to the governing law and the relevant level of account are compared below qualitatively as to their cost impacts and benefits, their economic and social impacts, their overall cost-effectiveness and their coherence.

#### **7.4.2 Effectiveness comparison**

The three options are equally effective in achieving the objective of simplification and consistency across EU member States, and would achieve the result of having rules in place that designate the same applicable law no matter where the case is examined within the EU.

A further aspect that stakeholders signalled as desirable is international consistency. On this aspect only the choice of law option (option 1) delivers fully. Option 2 is not compatible with the Hague Securities Convention and therefore would not deliver on international consistency. Option 3 offers the possibility of partial compatibility with the Hague Securities Convention. Not achieving international consistency means that the problem is solved in a European context, but remains unsolved in a global context, with negative implications on the risks, costs and feasibility of international transactions in securities. In terms of international consistency, only option 1 and partially option 3 deliver on rules that result in the same applicable law irrespective of whether the case is examined by an EU or a non-EU competent court or authority.

#### **7.4.3 Cost comparison**

Due to lack of quantitative data, **only a qualitative analysis of costs can be carried out**. All options would have some compliance cost implications on market participants, but given that under the current status quo there are already costs related to the lack of clarity and the inherent risks in cross-border transactions, the fact that there are **one-off switching costs to comply with the new rules does not mean that the options are not cost effective**. Currently

participants have to procure legal opinions on their cross-border transactions, often covering more than one substantive law that might be applicable. Under all of the three options presented in this impact assessment the rules on conflict of laws would be clear and harmonised across the EU, meaning that cross-border transactions would no longer be subject to legal uncertainty. **Legal opinions would still be needed for cross-border transactions**, but these would be **easier to obtain**, and would not need to cover several legal systems, as one single law would be applicable to any given cross-border transaction across the EU.

Option 1 has some **significant drawbacks on costs and negative impacts**: it is inconsistent with the current EU acquis, therefore it can impose higher costs of switching on CSDs, and it also risks having negative impact on third parties who will find it harder and more expensive to obtain information about the law applicable to the transaction. As for end investors, among them retail investors, they might find that the account provider with market power imposes the applicable law on them.

Option 2 (where the account was opened) has no negative impacts on account holders, third parties and CSDs. It would however, as shown above, be **less effective than option 1** as it is incompatible with the solution applied in jurisdictions outside the EU.

Option 3 achieves the objective of **international consistency only partially**, but it does **not have negative impact** on account holders, third parties and CSDs, and **is coherent** with the existing EU acquis.

A purely qualitative assessment shows significant trade-offs in the case of both Option 1 and Option 2. For Option 1, the positive economic impacts of international consistency would reduce risks and costs of cross-border transactions not only across the EU but also in an international context. However, that might be outweighed by negative social impacts and high compliance costs, as it departs from the current EU acquis. Option 2 does not impose as high compliance costs, as it does not depart fundamentally from the EU acquis, and it brings benefits in terms of legal certainty to end investors, without disproportionate costs on CSDs and custodians.<sup>104</sup> However, it does not deliver on international consistency and therefore its benefits are also lower. Option 3, similar to option 2, creates low negative effects and compliance costs, but the benefits it would achieve in terms of end investor protection would be somewhat lower, since the relevant level of account for individually segregated accounts is the account provided by the highest level intermediary where accounts are still segregated, and not the account provided to the end investor. This option would however deliver somewhat better on the objective of international consistency than option 2, but to a much lesser extent than option 1 (choice of law). Option 3 has the lowest negative impacts and cost implications, and achieves some benefits in terms of international consistency.

To recall, stakeholders' preferences are extremely divided between option 1 (choice of law) and any form of PRIMA (options 2 and 3). Financial sector actors<sup>105</sup> as well as Member States<sup>106</sup> are highly divided as to which option would be preferable in case of a legislative

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<sup>104</sup> This is due to the differentiated approach between individually segregated and omnibus accounts. See the replies of ECSDA and Euroclear to the public consultation, explaining why any deviations from the existing acquis would result in disproportionately high costs for CSDs.

<sup>105</sup> See the summary of responses to the public consultation in Annex 2.

<sup>106</sup> Ibid.

intervention. Given that the quantification of the costs and benefits is not possible, much of the problems are theoretical or speculative with no supporting evidence and the ultimate decision on which option is best greatly depends on how much weight policy makers put on the various trade-offs and on achieving international consistency (compatibility with conflict of laws rules applicable outside the EU, where US and Switzerland follow the same legal solution: The Hague Securities Convention). Keeping this in mind, option 3 is the option balancing best the objective of aiming for some international consistency with the constraint of potentially departing too radically from the current EU acquis that would be costly for some market participants or impose negative effects on end investors or third parties. However, it should be recalled that the findings are highly speculative and theoretical given the lack of concrete evidence.

#### **7.4.4 How do the legislative and non-legislative options compare?**

EU action on securities could take the form of a Regulation, an amending Directive or a Communication to clarify the Commission's views with regards to the existing provisions.

##### **7.4.4.1 Legislative intervention: Absence of material problem**

Under a legislative intervention a Regulation would repeal the three specific provisions in the three existing Directives. It would be directly applicable and would therefore prevent problems of divergent transpositions. It would however also have some significant cost implications, as indicated above in the analysis of options. Alternatively the initiative could take the form of an amending Directive to the FCD, SFD and WUD. Some stakeholders thought this was reasonable, since the main issues arise in the context of the situations that the three Directives cover. Clearer wording could address both divergent interpretations and any differences in wording and scope across the three Directives. This option would also entail the same trade-offs as indicated above in the analysis of options.

The three alternative legislative options are analysed and compared above. In light of the above analysis, it is clear that there are trade-offs in legislative intervention under each substantive option, and that stakeholders and Member States strongly diverge as to what the preferred option should be. Given that the problem is not material, i.e. no market disruption in cross-border securities transactions were found, and that the legal risk is residual at most, it appears that a non-legislative intervention would be a more proportionate response at this juncture.

##### **7.4.4.2 Non-legislative intervention: Improving clarity in the existing EU acquis**

The issuance of a Communication clarifying the Commission's views of the text of the existing conflict of laws provisions of the SFD, FCD and WUD would mean that the scope and wording of the Directives would remain unchanged. The Communication would however improve transparency of the existing rules across the European Union.

A clarification would bring more transparency and reduce the costs of legal opinions that transacting parties incur when trying to remedy the residual legal uncertainty that was identified in the evaluation. Although no precise figures are available on these costs, it is

estimated that a clarification through a non-legislative Communication would have a somewhat lower cost-reduction effect than a legislative amendment.

However the Communication can deliver on the objective of introducing more clarity without imposing significant adjustment costs and without unsettling the existing EU acquis that stakeholders warn against. It would also avoid disrupting national systems which work well, given that no evidence has been found of a material problem.

A legislative solution to address the theoretical and residual legal uncertainties is also considered to be premature at this stage given the strong divergence of views among market participants and Member States on the preferred option.

A Communication would be a quick tool to take action, and it would be the best way to preserve the existing EU acquis and to limit negative impacts while achieving real and strong benefits providing clarity to the existing rules.

A Communication might also be the most appropriate option in terms of future developments. International and technological developments might alter the preferred policy option on substance. First, in an international context further third countries might ratify the Hague Securities Convention. This international development would place into new perspective the objective to achieve international consistency. Secondly, future technological developments might change the cost benefit analysis of the substantive policy options. Distributed ledger technology is being tested and gradually introduced into various areas of financial markets. A legislative solution implies engagement with a policy direction throughout a long policy cycle from proposal to adoption of a measure, until entry into application. A communication would mean swifter action at present, leaving freedom to assess in the future, in light of international and technological developments, whether a more pronounced solution would achieve better results. It would be without prejudice to future decisions that might be made on the aforementioned issues by the Court of Justice of the European Union, which is responsible in the final instance for interpreting the Treaty and secondary legislation.

In light of these considerations and in terms of proportionality, a Communication **is the preferred form of action**. It follows the considerations that led to the selection of the preferred policy option; i.e. to achieve more legal clarity but at the same time avoid deviating too much from the existing EU acquis, and not to prejudice future international and technological developments. The Communication will provide clarity for market participants, without imposing compliance costs that could be disruptive for the market. More clarity as to the applicable rules will help decrease any cross-border risks related to legal uncertainty as well as transaction costs related to discovering the applicable law.

These benefits would accrue with financial intermediaries, and they might be passed on to end investors (enterprises – including SMEs – funds, retail investors, etc.). The benefits will be marginal, as the problem is not material to begin with. The benefits cannot be quantified due to lack of data.

In conclusion, a Communication would provide a proportionate response to the residual legal uncertainty of existing EU conflict of law rules in the field of securities.

It is also considered to be the most appropriate option in line with better regulation principles.

The negative impacts of such a Communication are expected to be minimal. Given that there is no substantial evidence of disruption in the market, the Communication will not seek to change the application of the Directives' relevant provisions, but rather to clarify the Commission's views with regards to the existing provisions.

In conclusion, the cost-benefit analysis confirms that a Communication would provide a proportionate and adequate response to the residual legal uncertainty of existing EU conflict of law rules in the field of securities:

	<b>Base line: no EU action</b>	<b>1. Legislative: Choice of law</b>	<b>2. Legislative: Law where opened</b>	<b>3. Legislative: Law where maintained</b>	<b>4. Non-legislative Communication</b>
<b>Effectiveness in achieving objectives</b>	0	Reduce costs of legal opinions: + + + Reduce losses: + + + ( Full harmonisation across the EU <i>and vis-à-vis</i> US & Switzerland – the Hague Securities Convention)	Reduce costs of legal opinions: + + Reduce losses: + + (full harmonisation across the EU)	Reduce costs of legal opinions: + + Reduce losses: + + (full harmonisation across EU & some situations compatible with The Hague Securities Convention)	Reduce costs of legal opinions: + Reduce losses: + (across the EU &, possibly some international convergence)
<b>Coherence with EU acquis</b>	0	(-) Departs from current EU rules	+ Coherent with current EU acquis	+ Coherent with current EU acquis	+ Coherent with current EU acquis
<b>Compliance costs</b>	0	(-) (adjustment costs, mainly on CSDs) (-) (negative effects on third parties)	(-)(-) (costs for CSDs and custodians having to offer accounts governed by different laws)	(-) (adjustment costs, mainly on CSDs)	(~ 0) (no material costs)
<b>Cost effectiveness</b>	0	No data available. Positive economic impacts might be outweighed by compliance costs and the applicability of non-EU laws, with potentially negative impacts on third parties and end investors (including retail investors).	No data available. Positive impacts are limited to intra-EU transactions, at a certain compliance cost. Would benefit some end investors, but at a cost ultimately likely to be passed on to them.	No data available. Positive impacts mainly for intra-EU transactions, at a certain compliance cost.	No data available. Positive impacts of clarification for intra-EU transactions, without legislative changes that would impose material adjustment costs.

## 8 IMPACTS OF THE PACKAGE OF OPTIONS ON CLAIMS AND SECURITIES

On claims, the preferred option is to adopt a proposal for a Regulation on the law applicable to the third-party effects of assignments of claims based on Option 4. The adoption of harmonised conflict of laws rules will bring legal certainty to market participants and thereby eliminate the current legal risk of possible financial losses where legal risk is unknown; of increased transaction costs if the legal risk is mitigated by due diligence and/or compliance with all possibly applicable national laws; or of missed business opportunities if legal risk deters parties from entering into cross-border assignments.

On book-entry securities, the preferred option is to issue a Communication clarifying the Commission's views with regards to the existing provisions, whose impact is expected to be a net positive impact, with benefits accruing from increased legal clarity. Although the evidence gathering exercise revealed that some uncertainty as to the interpretation of certain concepts of the existing EU Directives still existed, it also demonstrated that this residual legal uncertainty did not prevent the development of significant cross-border markets and that it is not expected to hinder the further development of cross-border activities. An interpretative Communication is expected to have some positive impact on reducing risks and transaction costs of cross-border transactions. It is not expected that the Communication would result in any material compliance cost or other costs for stakeholders and Member States.

The overall package of options (a Regulation on the law applicable to the third-party effects of assignments of claims and a Communication on transactions in securities) will increase legal certainty and foster cross-border investment. Neither of the two preferred options' impacts can be quantified in monetary terms.

## **9 HOW WOULD ACTUAL IMPACTS BE MONITORED AND EVALUATED?**

The Commission will monitor the impacts of the proposed initiative on claims by way of a questionnaire sent to key stakeholders. The questionnaire will aim at gathering information on trends in the number of cross-border assignments, trends in due diligence costs further to the adoption of a uniform rule, and the one-off costs related to changes in legal documentation. The impact of the proposed solution on claims will be evaluated in a report prepared by the Commission five years after the entry into force of the proposed instrument.

The monitoring of the impacts of the adoption of a uniform rule will cover the areas of factoring, securitisation, collateralisation and the specific assignments of cash credited to an account in a credit institution and of claims arising from financial instruments such as derivative contracts.

The analysis will keep in mind that the volume of transactions, the transaction costs and the nature of hidden risks in claim assignments are influenced by a number of different economic, legal or regulatory factors unrelated to legal certainty on the applicable law.

As for securities, the Communication will call on stakeholders and Member States to signal to the Commission if they observe specific cases where legal uncertainties cause disruptions in the market or any disproportionate costs. A targeted questionnaire will be sent to Member States and key stakeholders from the financial sector five years after the adoption of the Communication to assess the situation. The feedback from the questionnaire will be assessed and published. The assessment will also take account of international and technological developments in the field to examine whether legislative intervention is needed.

## 10 GLOSSARY OF TERMS

This Glossary defines the technical terms used for the purposes of this impact assessment only.<sup>107</sup> These definitions are without prejudice to the existing EU acquis.

**Account agreement:** The agreement between the account holder and the relevant intermediary governing the securities account.

**Account holder:** A person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary).

**Applicable law:** The national substantive law designated as applicable by the conflict of laws rules of the forum.

**Assignor:** a person who transfers his right to claim a debt against a debtor to another person.

**Assignee:** a person which obtains the right to claim a debt against a debtor from another person.

**Assignment:** voluntary transfer of a right to claim a debt against a debtor. It includes outright transfers of claims, contractual subrogation, transfers of claims by way of security and pledges or other security rights over claims.

**Book-entry securities:** An electronic recording of securities or other financial assets. The transfer of book-entry securities and other financial assets does not involve the physical movement of paper documents or certificates. For the purposes of this impact assessment the term book-entry securities will refer to all book-entry financial instruments, as legally defined in point (ii) of Article 2(9) of Insolvency Regulation Recast as meaning “*financial instruments, the title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary*”.

**Book-entry system:** A mechanism that enables market participants to transfer assets (for example, securities) without the physical movement of paper documents or certificates.

**Central counterparty (CCP):** An entity which operates as the buyer for every seller and as the seller for every buyer so that the parties only bear the credit risk of the CCP.

**Central securities depository (CSD):** An entity that provides the initial recording of securities in a book-entry system or that provides and maintains the securities accounts at the top tier of the intermediated holding chain. The entity may provide additional services such as clearing, settlement and processing corporate actions. It plays an important role in helping to

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<sup>107</sup> This Glossary relies on the Glossary of the UNIDROIT Draft Legal Guide, which in turn includes the definitions and descriptions provided by the Geneva Securities Convention and the OFFICIAL COMMENTARY and, for other terms, relies to the extent possible on the definitions provided by CPMI’s glossary of terms used in payments and settlements systems.

ensure the integrity of securities issues, i.e. that there are no more securities in circulation than there were securities issued.

**Claim:** the right to claim a debt of whatever nature, whether monetary or non-monetary, and whether arising from a contractual or a non-contractual obligation. The United Nations Convention on the Assignment of Receivables in International Trade uses the term receivable to refer to the claim.

**Clearing:** The process of transmitting, reconciling and, in some cases, confirming transactions prior to settlement, potentially including the netting of transactions and the establishment of final positions for settlement. Sometimes this term is also used (imprecisely) to cover settlement.

**Close-out netting provision:** A provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise: (a) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount; (b) an account is taken of what is due from each party to the other in relation to such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

**Corporate actions:** Events called or initiated by an issuer of securities concerning the securities and the holders of the securities.

**Corporate law:** The area of law dealing with the formation and operation of a company, which in particular includes the rights of shareholders.

**Distributed ledger technology:** A distributed ledger is essentially a record of information, or database, that is shared across a network. It may be an open, publicly accessible database or access may be restricted to a specified group of users. It can be used to record transactions across different locations. Individual transactions are stored in groups, or blocks, which are attached to each other in chronological order to create a long chain, and is secured to protect the integrity of the data. This chain then forms a register of transactions that its users consider to be the official record.

**Eurosystem:** The Eurosystem comprises the European Central Bank and the national central banks of those countries that have adopted the euro.

**Immobilisation:** The act of durably concentrating the holding of securities certificates with a depository to allow the crediting of an equal amount of securities to securities accounts and the transferability of such securities by way of book entry.

**Individually segregated account:** An account structure in which a specific intermediary holds the securities belonging to one or more account holders in an account with its own (relevant) intermediary that is distinct (segregated) from the securities it holds for itself or for other account holders.

**Intermediary:** A person (including a CSD) who in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity.

**Intermediated holding chain:** A term used to describe the relationship and interaction among the (possibly many) tiers of participants in an intermediated securities holding system.

**Intermediated securities:** Securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account.

**International consistency:** In respect of securities The Hague Securities Convention applies in the United States and Switzerland, as well as in Mauritius. In this impact assessment the term international consistency refers to rules that are consistent with The Hague Securities Convention.

**Investor:** A person or entity, such as individuals, companies, pension funds and collective investment funds, who acquire securities to make a profit or gain an advantage.

**Issuer:** A government or entity such as a company which issues securities.

**Netting arrangements:** An arrangement by which debits and credits in respect of securities of the same description may be effected on a net basis.

**Priority:** the right of a person in preference to the right of another person. Ranking among competing interests with respect to the same intermediated securities or with regard to the same claim.

**Private law:** The area of law which regulates the relationships between individuals and private entities (e.g. contract law, tort law, etc.).

**Relevant intermediary:** The intermediary that, in relation to a securities account, maintains that securities account for the account holder.

**Securities account:** An account maintained by an intermediary to which securities may be credited or debited.

**Securities settlement system (SSS):** A system that settles, or clears and settles, securities transactions and is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in relation to its rules. To qualify as a SSS under the Geneva Securities Convention, it must also be identified as such in a declaration made by the Contracting State the law of which governs the system on the ground of the reduction of risk to the stability of the financial system. See paragraph 70.

**Security interest:** A security interest is a limited interest in assets (such as a lien, pledge, charge, or title transfer) which secures an obligation.

**Settlement:** A process which discharges the obligations arising out of the agreement of the parties to transfer securities. Securities settlement may represent the conclusion and fulfilment of a stock exchange transaction between two or more parties (i.e. a trading object is

exchanged for a cash counter value). Resulting obligations can be redeemed either in central bank or book money. Settlement is normally preceded by clearing.

**Transparent systems:** Systems in which an investor's particular holdings are identified by, or known to, the CSD primarily because the role of maintaining a securities account is shared between the CSD (which is the relevant intermediary for the purpose of the Geneva Securities Convention and the Guide) and other persons often called account operators, such as investment firms, securities dealers, etc.

## **ANNEX I: PROCEDURAL INFORMATION**

### **1. LEAD DG, AGENDA PLANNING AND WORK PROGRAMME**

This impact assessment and the related initiatives are a shared responsibility of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (FISMA) and the Directorate-General for Justice and Consumers (JUST). In the Agenda Planning of the European Commission, the project is referred to under PLAN/2016/227. The project is based on the Capital Market Union Action Plan, which envisages a targeted action on securities ownership rules and the third-party effects of the assignment of claims.

### **2. ORGANISATION AND TIMING**

Work on the preparation of this initiative started in September 2015 with the CMU Action Plan. The impact assessment was prepared with the involvement of the following Services through the Inter-Service Steering Group, chaired by the Secretariat General:

the Commission's Legal Service;

DG Internal Market, Industry, Entrepreneurship and SMEs;

DG Climate Action;

DG Competition, and

DG Economic and Financial Affairs.

The Steering Group met on three occasions, between 22 March 2017 and January 2018, including one meeting on the preparation of the consultation document for the public consultation. On each occasion, the members of the Steering Group were given the opportunity to provide comments orally and/or in writing on the draft versions of the documents presented, including the draft consultation document and the draft impact assessment.

### **3. CONSULTATION OF THE REGULATORY SCRUTINY BOARD**

The impact assessment report was submitted to the Regulatory Scrutiny Board on 8 November 2017. The RSB reviewed the impact assessment at a meeting on 13 December 2017 and gave a negative opinion, calling for it to be resubmitted.

The Board made the following observations:

- The report does not adequately reflect how markets have responded to perceived risks in securities. It should indicate whether this reduces concerns about securities.
- The report does not show how the preferred options would solve the problems as they are described. This applies to conflicts between EU rules and global rules for securities, and to general rule derogations for claims.
- The report does not address the problems for securities and claims in a balanced way.

Following the Board's recommendations, the impact assessment was revised as follows:

- On the structure of the impact assessment, more emphasis was put on issues relating to assignments of claims. The part on securities was shortened and clarifications were added;
- The problem description was streamlined to delineate where appropriate the differences between claims and securities;
- The preferred options were explained in more detail;
- Further information on the international context and particularly on the Hague Securities Convention and the United Nations Convention on the Assignment of Receivables in International Trade was added;
- A glossary of the main terms used in the impact assessment was included.

The impact assessment report was resubmitted to the Regulatory Scrutiny Board on 19 January 2018. The RSB rendered a positive opinion with reservations on 1 February 2018.

The Board acknowledged that the report had been significantly reworked to reflect the recommendations. The Board, however, made the following observations:

- The report does not sufficiently justify the preferred option on securities in relation to the findings of the evaluation. It is not sufficiently clear whether costs linked to 'conflicts of law' will continue for international securities transactions;
- The report does not address the consistency between the two solutions found for claims and securities.

Following the Board's recommendations, the impact assessment was revised as follows:

- The preferred option for securities, a Communication providing the Commission's views on the existing EU acquis is now analysed on a par with other policy options;
- Further clarification as to the consistency between the two solutions was inserted;
- The cost analysis of the different options for securities transactions was analysed in more detail;
- Simpler language was used in the text of the impact assessment.

## 5. EXTERNAL EXPERTISE

The Commission consulted widely and received input from various sources for this impact assessment work.

Evidence used in this impact assessment was gathered following a consultation strategy which included a consultation with industry experts through a High Level Group of experts (European Post Trade Forum), an Expert Group on conflict of laws regarding securities and claims<sup>108</sup> and a public consultation through an on-line questionnaire accompanied by a consultation document<sup>109</sup>. The public consultation strategy is described in detail in Annex 2.

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<sup>108</sup><http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3506&NewSearch=1&NewSearch=1>

<sup>109</sup> Responses to the public consultation and consultation document available here: [https://ec.europa.eu/info/consultations/finance-2017-securities-and-claims\\_en](https://ec.europa.eu/info/consultations/finance-2017-securities-and-claims_en)

On 18 September 2017, the Commission held a meeting with Member State's experts on conflicts of laws to inform them of the planned initiative and the solutions envisaged. While some Member States expressed a preference for the law chosen in their national law, a majority of Member States did not express a position. On 8 November 2017, the Commission held a meeting of Member States' experts on conflict of laws in securities and claims that are relevant for financial markets. On securities, the vast majority of Member States voiced support for a Communication clarifying the Commission's views with regard to the existing provisions of the three Directives.

The Commission services have taken into account the observations from all the above-mentioned sources in the impact assessment.

## **ANNEX 2: STAKEHOLDER CONSULTATION STRATEGY**

The objective of the public consultation was to receive input from all concerned stakeholders, and in particular those who engage in or are affected by the practice of factoring, securitisation, collateralisation, as well as legal counsels and experts familiar with conflict of laws on third party effects of transactions in claims and securities. Member States and supervisory authorities were also invited to provide their input.

The consultation strategy included consultation with industry experts through a High Level Group of experts called European Post Trade Forum (EPTF), consultation with renowned legal experts through a separate High Level Group of experts and a public consultation through an on-line questionnaire accompanied by a consultation document. Member States were also consulted.

The EPTF published its report on 23 August 2017. This report examines the post-trade barriers to the Capital Markets Union and it lists the current divergent conflict of laws rules with regard to the law governing proprietary aspects of transactions in securities and third party effects of assignment of claims as one of the barriers requiring EU action.

With regard to securities the High Level Group of legal experts proposed two alternative solutions, which are both examined in the impact assessment accompanying the initiative.

On 8 November 2017, a meeting was held with Member States on conflict of laws in securities and claims that are relevant for financial markets. On securities, the vast majority of Member States voiced support for a Communication clarifying the Commission's views with regards to the existing provisions.

The published inception impact assessment received one feedback from the Association for Financial Markets in Europe, who welcomed this regulatory initiative, particularly supporting the proposed form of a Regulation to avoid discrepancies of transpositions into national laws by Member States. At the same time they called for further clarification and substantiation of the scope of the initiative with regard to claims. This has been done in the impact assessment.

The public consultation opened on 7 April 2017 and closed on 30 June 2017, which complies with the minimum standards of 12 weeks for public consultations of the European Commission. 39 responses were submitted to the consultation, and among the respondents there were 5 governments or Ministries, 15 industry associations, 4 companies, 2 law firms, 2 think tanks and 5 private individuals. From the financial sector the interests of banks, fund managers, regulated markets, CCPs, CSDs, issuers and investors were represented. There were no replies from consumer organisations. The analysis of impacts in the impact assessment therefore pays particular attention to any impacts on consumers and retail investors.

In terms of geographical coverage the public consultation reached a number of different Member States, but smaller countries and newer members of the EU were largely under represented. 13 responses were submitted from the UK, 9 responses were received from France, and the same number from Belgium, 3 responses from Germany and 3 from the

Netherlands, 2 responses came from Spain, and 1 from Finland, the Czech Republic and Sweden each. In our assessment we acknowledge the limited geographical coverage of the consultation results. The analysis of the alternatives options in the impact assessment have regard to all Member States of the EU and is not limited to the countries from which responses were received.

The methodology used to process the data consisted in quantitative and qualitative analysis of the responses. Very little data was submitted that could support the impact assessment. However the anecdotal evidence supplied by respondents were used in the impact analysis.

## 1. Claims

**In general**, when asked whether there have been problems encountered in practice in securing the effectiveness of assignments of claims against persons other than the assignee and the debtor in transactions with a cross-border element in the past five years, 11 stakeholders replied that there have been problems, 5 stakeholders denied having encountered problems and 21 did either not know or did not give an answer. Out of the 39 stakeholders that responded to the question whether they see added value in Union action to address the identified issues in the area of assignment of claims involving a cross-border element, 59% answered positively, 22% denied added value and 18% did not have an opinion on this. The stakeholders who denied added value argued that Art. 14 (2) of the Rome-I Regulation was sufficient and that they have not experienced any difficulties with the current regulation.

As to what the best connecting factor of such an EU act would be, stakeholders were requested to indicate an order of preference ranging from 1 (best solution) to 4 (least preferred solution). 57% favoured the law of the assignor's habitual residence as "best solution" and 43% favoured the law of the assigned claim. The law applicable to the assignment contract as connecting factor was least favoured as "best solution" by only 30% of the stakeholders.

For the law of the assignor's habitual residence it was laid out that this law could be determined easily and would imply great legal certainty as well as respect more than any other approach the economic logic of important trade practices. For the law of the assigned claim it was put forward that this applicable law would comply with the principle of party autonomy, would guarantee consistent outcomes as between competing assignments of the same asset and potentially lower transaction costs. Contrary to the first option the applicable law cannot be foreseen by third parties in this case. For the third option of the law applicable to the assignment contract, it was advocated that this rule would give necessary clarity, prevent surprises and be uniform with Art. 14 of the Rome-I Regulation.

The public consultation asked the stakeholders what the scope of the applicable law on the assignment of claims should be. To this only 50% of stakeholders gave a reply. Out of the replies received 38% advocated for the steps necessary to render rights in claims effective against third parties while nearly the same amount of 36% recommended priority issues and 25% favoured something other.

**With respect to the positive impacts of the option of assignor's habitual residence**, a financial industry stakeholder indicated that supported the law of the assignor as the most suitable connecting factors due to a number of reasons: bulk nature of assignments of both present and future receivables, often of small value do not allow time or expense of individual

checking; invoice by invoice checking of the applicable contract law is impracticable; finance providers will always be aware of the habitual residence of their clients and the law thereunder for third party claims; many receivables arise under informal arrangements where there is no written contract and thus the applicable law of the claim will be difficult to ascertain and the choice may well be disputed.

Another stakeholder from the financial industry indicated that the applicable law of the assignor is foreseeable for both assignor and assignee (even if it is a choice of law made only on conclusion of a contract) is an advantage which increases legal certainty and makes expansion into other jurisdictions possible. The applicable law according to this option (which is favoured by the European factoring industry) has the advantage of being foreseeable for all involved and affected parties, thereby decreasing the risk of disputes especially with third parties. In his view only the law of the assignor, i.e. the law of the place where the assignor has its centre of main interest, offers a well-balanced solution to the issue of the law applicable to the priority of parallel assignments and to the effectiveness of assignments towards third parties. The law of the assignor is predictable not only for the assignment parties but also for third parties. It thereby considers the interests of these third parties while not leaving the interests of the assignor and the assignee aside. Moreover, the law of the assignor generally also decides on the consequences in case of the insolvency of a factoring client/assignor. Submitting the questions of priority and effectiveness of assignments against third parties to the law of the assignor would thus lead to synchronising effects also with regard to insolvency procedures.

Last but not least, applying the law of the assignor to fill in the aforementioned regulatory gap would also entail that the Rome I Regulation is in line with international conventions on the conflicts of law i.e. the 2001 UN Convention on the Assignment of Receivables in International Trade which in its Art. 22 also uses “the law of the State in which the assignor is located” as connecting factor. Such a synchronisation of rules on the conflicts of laws contained in different European and international legislative documents enhances legal clarity and makes practical implementation simpler. By defining the law of the assignor as the law of the place where the assignor has its habitual residence or centre of main interest (which for businesses generally is the place of their central administration), the rules contained in Art. 19 para. 1 of the Rome I Regulation would not only be synchronised with Art. 5 (h) of the aforementioned UN Convention, but also with Art. 3 para. 1 of the Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings. As most questions with regard to the effectiveness of an assignment against third parties arise upon the insolvency of the assignor, such a synchronisation would be advantageous.

A banking industry representative stated that the law of the assignor’s habitual residence should be preferred over any other solution. The habitual residence should be appreciated on the assignment date. A decrease of legal due diligence costs is obvious but will not affect most the deals. A clear rule of conflict of laws will mostly enable European banks to propose more competitive deals to their clients (i) predictability for third parties: as the assignor is known to all, there would be an objective, clear rule of connection; (ii) solution consistent with that used internationally by UNCITRAL Convention on the Assignment of Receivables in International Trade; (iii) solution suited to rules concerning insolvency proceedings (regulation 1346/2000) in the event of the assignor’s bankruptcy: given that the assignment of claims reduces the assignor’s assets and therefore affects the rights of other creditors, it is entirely appropriate that the same law should apply to the effectiveness of the assignment

against third parties and assignor bankruptcy, (iv) - definite advantage when future claims are assigned, insofar as the assignor is known from the outset, which is not the case with the assigned claim or debtor, (v)- solution also appropriate in cases where a portfolio of claims is assigned (all claims by a single assignor; e.g. securitisation, factoring, etc.), as this avoids the cumulative application of several laws when debtors fall under different jurisdictions, and applies a single law to the effectiveness of the assignment of all claims against third parties. This also reduces the cost of legal research, which would have been incurred through the application of different national laws, and ensures better visibility for third parties while simplifying formalities to be completed.

Law of the assignor's habitual residence appears also appropriate in cases where a portfolio of claims is assigned (all claims by a single assignor; e.g. securitisation, factoring, etc.), as this avoids the cumulative application of several laws when debtors fall under different jurisdictions, and applies a single law to the effectiveness of the assignment of all claims against third parties. This also reduces the cost of legal research, which would have been incurred through the application of different national laws, and ensures better visibility for third parties while simplifying formalities to be completed.

**With respect to the negative impact of the option of assignor's habitual residence**, one financial industry stakeholder stated that the over-riding requirement to use the law of the place of the assignor's habitual residence to resolve third party aspects would increase the number of cases where the outcome was potentially in conflict with (i) the public policy laws of the jurisdiction of the original debtor of the law by which its contract with the assignor is governed (if different) and possibly relevant property laws of that jurisdiction; or (ii) the property law of the jurisdiction of the contract between the assignor and the assignee; or (iii) the property laws of the jurisdiction of the law of the contract or other legal situation under which the third party acquired rights which it can assert in relation to the underlying debt, which could potentially be different from the law of the habitual residence of the debtor, the law of the contract or other legal situation which created the original debt owed to the assignor, the law of the contract between the assignor and the assignee and the law of the habitual residence of the assignor.

A banking industry stakeholder mentioned that the law of the assignor's habitual residence offers a considerable degree of predictability and certainty for the creditors of the assignor, in particular with regard to corporate/legal as the law applicable at the registered seat of such entity. However, in particular with regard to natural persons the degree of predictability and certainty is much lower since the habitual residence can change with time. In addition, this option may lead to a split of laws in a transaction with more than one assignor residing in different countries.

**With respect to the positive impact of the option of the law of the assigned claim**, one financial industry stakeholder indicated that it would support use of the governing law of the assigned claim as the connecting factor (i.e. the basis on which the securitisation industry has generally been operating) to further support the approach that the securitisation industry has generally been taking in practice, using the law governing the assigned claim as the connecting factor. In her view using the governing law of the assigned claim could result in additional costs and the creation of new issues and uncertainties, hampering cross-border activity. This would adversely affect securitisations, especially for SMEs or small businesses,

where there is often no critical mass of claims in any one jurisdiction and so cross-border securitisations are currently more common.

Another financial industry stakeholder set out reasons for favouring the law governing the assigned claim, which include: (i) alignment with the principle of party autonomy; (ii) its ability to guarantee consistent outcomes as between competing assignments of the same asset; (iii) the ability of the underlying debtor to identify the person entitled to lay claim to the debt in priority to other assignees, which is observed to be of consequence; and (iv) the potential for lower transaction costs. Moreover, in her view a) the use of this connecting factor helps to minimise fraud risk by ensuring that the entitlement of an earlier-in-time assignee will not be subject to the application of a new and unpredictable system of law prioritising the entitlement of a later-in-time assignee (for example, because of notarisation requirements); b) where the same law governs effectiveness against the debtor and effectiveness against third parties, there is reduced scope for legal uncertainty which might otherwise arise given the potential for alternative characterisations of a legal issue before a court; c) it may prove difficult to obtain a clean legal opinion providing comfort as to the location of the habitual residence of an assignor, as this is a question of fact and not law; and d) where assignors are tied to the law of their habitual residence, requirements i.e. notarisation and registration imposed by the law of their habitual residence for the purpose of establishing the priority of the assignee's title may create a "drag" on the transaction, particularly in the case of bulk assignments, and disadvantage the assignor.

Also one public authority indicated that main advantages of this solution are the stability of the connecting factor and the avoidance of increasing the number of applicable laws to an assignment. However, this rule might need an adjustment e.g. in case of assignments of claims under future contracts and bulk assignments.

**With respect to the negative impact of the option of the law of the assigned claim**, one financial industry stakeholder stipulated that in the context of a cross-border securitisation where the securitisation pool contains claims with different governing laws, multiple assignments are typically used such that the law of the assignment matches the law of the underlying claims. The transaction opinion(s) would typically cover the effectiveness of each assignment under its governing law. Additional legal due diligence may be carried out to ascertain whether that same governing law will be recognised as governing third party effects of the assignment in the originator's jurisdiction (if different) and in any debtor jurisdictions. In some cases, if the initial legal due diligence identifies issues in certain jurisdictions, the commercial solution taken may be to remove the 'problematic' agreements from the pool rather than attempt to secure the effectiveness of the assignment against third parties in those jurisdictions.

A factoring industry stakeholder underlined that due to the predominance of bulk assignments in factoring, it is unfeasible to establish for each claim/receivable which law is applicable, especially if each claim were to underlie a different law. Hence, this option would most likely lead to a significant decrease in cross-border factoring transactions. Cross-border transactions which involve the assignment of many claims /receivables (especially bulk assignments) would become more unattractive due to the many different applicable laws.

Banking industry stakeholder mentioned the application of the law of the assigned claim would lead to high complexity if there is an assignment of more than one claim

(securitisation, factoring, etc.): need to comply with several laws to make the assignment effective against third parties. Furthermore, such a conflict of law rule would require to research the law of the original claim when the parties have not expressly designated this in their contract. Besides, further objections to the application of the law of the assigned claim remain (i) this law is not consistent with the law applicable to the assignor's bankruptcy although in practice, the law of the assignor's habitual residence has always to be taken into account in the event of the assignor's bankruptcy, (ii) the law of the original claim is not necessarily known to third parties, and will have to be researched when the parties have not expressly designated this in their contract. Another banking industry stakeholder explained that In a typical trade receivables Transaction, for instance, where the assignor (a supplier of goods or services) assigns claims against debtors (its customers, the buyers of such goods or services) in various countries, this option may lead to a split of the laws governing those claims and hence the laws governing the effects of assignment to third parties, which may lead to considerable uncertainty and also increased costs and administrative burden and which may, in fact, restrict the opportunities of the assignor to refinance its transactions.

## 2. Securities

The consultation asked stakeholders **whether legal opinions are covering the question of applicable law always when relevant or not**. While 20% of respondents did not provide an answer, only 25% of respondents thought that the question of applicable law was adequately addressed in all relevant situations. Almost 50% of respondents thought legal opinions do not always assess the applicable law where such question would be relevant for the transaction.

Respondents were slightly more divided on the question whether the default of a large participant in financial markets could raise difficult questions as to which law is applicable and who is the owner of (or has entitlement to) which assets. While 33% did not think this was likely, 46% argued that this is likely to happen, and 21% did not know or did not provide any answer to this question.

As to the **applicable EU conflict of law rules**, about one third of the respondents did not provide answer. Of those who did, 62% considered that it was not clear how to apply applicable EU conflict of law rules. The technical details provided by respondents were used in the evaluation that is annexed to the impact assessment, as well as in the impact assessment itself. It has to be mentioned also that 18 Member States also provided answers to a technical questionnaire on how EU rules are transposed and applied. Those answers were used alongside the responses from stakeholders to the public consultation. The evaluation also gives detailed feedback on the responses received.

The public consultation asked stakeholders' views about the **value added in EU action to harmonise applicable conflict of laws rules** in this field. To this question 19 respondents answered positively, i.e. they see added value in EU action, and 9 respondents thought EU action would not have added value.

The detailed arguments of stakeholders who argued against EU intervention were analysed in detail, and can be distinguished into two main groups: the fear of upsetting the current status quo that CSDs rely on, and the apparent lack of problem in France. A group of 3 respondents submitted the former argument, namely that any variation in the current status quo could alter the current legal basis that securities settlement systems are relying on. Therefore the impact

assessment pays particular attention to this angle, so that the preferred policy option does not produce disproportionate undesirable effects. Another group of 4 respondents argued that there were no problems with the currently applicable EU rules, and therefore EU intervention is not necessary. This argument is taken into consideration in the analysis of the impact assessment, along with replies from other Member States indicating opposite views.

Two additional arguments against EU intervention were submitted. One respondent argued that there was a real risk that if steps were taken to harmonise the laws determining ownership entitlement of end investors without addressing related issues of over-allocation of securities accounts through the holding chain, a securities issuance could in effect become inflated, with more rights to securities being capable of being exercised than there were securities issued. Finally, another respondent argued that a full EU codification could be destructive because it could only capture that part of the flows that can be attributed to the EU territory and would, as the entire codification tradition, still have serious problems with customary law and general principle and would set commerce and finance in concrete. These aspects were therefore also considered in the impact assessment.

Those who argued for EU intervention pointed to the lack of clarity in the applicable rules, the legal uncertainty that results from it, and the efficiency gains it could produce. "We believe that this reform would be beneficial in providing for legal certainty, including in the context of taking collateral." "...harmonisation of the definition of securities to which the rule applies would be very helpful and would remove uncertainty and produce efficiency savings."

When asked about the **form and scope of intervention**, 11 stakeholders were of the opinion that targeted amendments to existing EU legislation (SFD, FCD and WUD) would be sufficient, among them some of those who argued no intervention is needed (6 respondents). 9 respondents favoured an overarching reform, i.e. a separate legal act that would specify the applicable law to third party effects of transactions in securities. In addition, 7 respondents thought that both solutions – targeted amendments or an overarching reform – could be effective.

The argument of those in favour of targeted amendments, rather than an overarching reform included fears of a complete overhaul in the existing EU acquis: "we see major legal uncertainty in a complete overhaul in the paradigm of the current conflict of law rules". The argument of those in favour of an overarching reform was that a "targeted amendment of the existing EU conflict of law rules would hardly be worth the effort, as it would only apply to the specific situations covered by those rules and would leave the conflict of laws issues relevant to cross-border holding of securities largely unsolved. If the goal is to enhance legal certainty in a significant way, a more universal legal framework covering third party effects of transactions in book-entry securities is needed." It was also argued that: "If the EU legislation does not cover all aspects of account-credited securities, this will lead to problems of compatibility with the Hague Securities Convention (entered into force this year by ratification by the U.S.). Moreover, a partial solution for special kinds of account-credited securities and trading conditions would not minimize the uncertainty of the law applicable – in fact, the problems could actually increase." Several further respondents confirmed these views, and it is worth noting that the EPTF Report also concurs in its findings.

The public consultation tested options on the governing law. 7 respondents expressed preference for the choice of law option, and 9 preferred a definition of the applicable law

based on PRIMA (of which 2 respondents would leave it to parties to define contractually the relevant intermediary). Of those respondents who see no added value in EU action, 6 replied that they would prefer PRIMA, should policymakers decide to put forward a legislative proposal.

In several responses the reason provided for the choice of PRIMA as the preferred option was that respondents were aware that adopting the Hague Securities Convention, which would otherwise be their own preferred option, was politically not feasible, due to resistance from other stakeholders. These respondents stressed however that the definition of PRIMA should be as close as possible to the definitions used under the Hague Securities Convention. At the same time there were also respondents preferring PRIMA due to a fear of "major legal uncertainty in a complete overhaul in the paradigm of the current conflict of law rules", as already quoted above. Two stakeholders preferred the issuer's law and 6 other proposals were made that were mainly variants of PRIMA and Hague, for example the place of the relevant account approach, a limited right to parties to choose the applicable law, etc.

Some respondents preferring PRIMA did not give further clarifications on **how PRIMA could be defined**. 12 respondents specified their preference as to where within a holding chain the relevant account should be. 9 of them argued in favour of a separate relevant account at each level of the holding chain, while 2 other preferred one single level, one of them specifying that it should be at the bottom of the holding chain (bottom line account). On the question how to identify the relevant intermediary, fewer respondents provided answers. Of those who did, 6 respondents thought the place of the relevant intermediary could be identified through the intermediary's branch through which the account agreement is handled, which could be either contractually stipulated (3 respondents) or identified by an account number (1 respondent). One other respondent expressed preference for the intermediary's registered office, rather than the branch.

Only 4 respondents considered that conflict of laws rules on third party effects of transactions in **certificated securities** should be harmonised at EU level, while 10 respondents did not see added value in taking action on certificated securities. The rest of the respondents did not provide any answer to this question. The most frequent argument for taking no action was that certificated securities are not being used very much anymore, and that conflict of laws rules on these are probably not as divergent as on book-entry securities. In line with the view of most responses, the scope of harmonisation will be limited to book-entry securities.

In terms of quantitative data and impacts of various policy options the consultation delivered little results. The few references to the size of the problem and anecdotal evidence that stakeholders submitted were taken into account in the impact analysis.

### **ANNEX 3. WHO IS AFFECTED BY THE INITIATIVE AND HOW?**

Legal uncertainty has different consequences for different types of players, i.e. retail investors, institutional investors, financial intermediaries and CCPs, to mention a few major categories of impacted parties. The proposal will have different impact on these categories of participants. Below the main impacts are reviewed from the package of preferred options.

#### **Enterprises, including SMEs**

In relation to the third-party effects of the assignment of trade receivables (claims), the law of the assignor's habitual residence would increase the possibility of obtaining financing for enterprises, including SMEs, since it would allow those enterprises to offer their future claims against their non-domestic clients as a security to the banks which provide them with credit. At the same time, the law of the assignor's habitual residence would be beneficial for enterprises, including SMEs, wishing to sell their invoices (claims) against non-domestic clients to factoring industry. Companies would, thus, be positively impacted by the application of the assignor's law.

By contrast, since law of the assigned claim is usually better matched with the law under which the claim is ultimately enforced, the application of the assigned claim law could have a beneficial effect on selling and enforcing existing individual claim of a higher value;

Enterprises and SMEs could possibly also benefit from marginal decrease in cross-border transactions costs in securities. However the effects are expected to be small when taking into account that the overall cost reduction benefits would have to be calculated at the level of each individual transaction and would be conditional on intermediaries passing on these benefits to clients. Similar marginal benefits might accrue with other end investors, including funds or retail investors.

#### **Banking and factoring industry**

The banking industry believes that the law of the assignor will would decrease the due diligence costs and would enable European banks to presents more competitive deal offers to their clients. At the same time, the banking industry is of the opinion that the law of the assigned claim may lead to restriction of opportunities for assignors, i.e. businesses and SMEs, to refinance their transactions.

The law of the assignor's habitual residence would be beneficial for enterprises, including SMEs, wishing to sell their invoices (claims) against non-domestic clients to factoring industry which the factoring industry, in turn, could treat more easily and with lower costs. The factoring industry would, thus, be positively impacted by the application of the assignor's law. On the other hand, due to the prevalence of bulk assignments in factoring involving multiplicity of claims law of the assigned would increase the costs of factoring transactions and, thus, have a negative effect on development of factoring activities.

Financial intermediaries would benefit from more legal certainty on the applicable law to proprietary effects of securities transactions in terms of reduced legal costs and reduced risks. In addition, they should not face any compliance costs when switching to the new rules

following the Communication clarifying the Commission's views with regards to the existing provisions.

### **Securitisation industry**

The securitisation industry is divided as to the effects of the assignor's law on securitisation activities: certain members of this industry consider the law of the assignor's habitual residence as the most beneficial conflict of law rule allowing for expansion of securitisation transactions involving multiple jurisdictions. Other members of the securitisation industry see the a negative impact of the assignor's law on securitisation transactions due to the possible problem of enforceability resulting from the discrepancy of the law applicable to third-party effects and the law applicable to the enforcement of the claim.

Similarly as with respect to the law of the assignor, the securitisation industry is split as to the effects of the law of the assigned claim on securitisation transactions: some of the players who already use the law of the assigned claim as a connecting factor believe that the change of this connecting factor would adversely affect cross-border securitisation activities; by contrast, other persons involved in the securitisation industry claim that the law of the applied claim would render securitisation transactions more complex and, thus, would represent an impediment to the securitisation business.

### **All market participants**

The introduction of uniform conflict of laws rules at EU level may generate one-off costs related to the need for market participants involved in cross-border assignments of claims to check and eventually amend the legal documentation they currently use. These one-off costs can be expected to be small: they will consist of the fees paid by market participants to their legal counsel to carry out a one-off compliance check with the new conflict of laws rules. The exact amount of such costs will depend on the length and complexity of the legal documentation used as well as on the rates agreed between the market participants and their legal counsel. Market participants whose legal documentation needs to be modified following the introduction of the new rules will bear additional, but equally non-significant, one-off costs for the revision of their current legal documentation to accommodate it to the new conflict of laws rules.

#### ANNEX 4. DATA SOURCES AND QUANTIFICATION OF IMPACTS AND COSTS

This impact assessment does not rely on modelling. Quantification of the costs stemming from legal uncertainty of applicable law to cross-border transactions in securities was carried out based on the following assumptions and sources.

It is generally accepted that cross-jurisdictional legal uncertainty stemming from conflict of laws increases the cost of capital and reduces the value of securities to investors and secured creditors. As such, it can also make securities less valuable as collateral and thus constrain the flow of credit in an economy.<sup>110</sup> The cross-border legal uncertainty affects negatively the beneficiaries of these instruments, such as pension schemes, collective investment schemes, asset managers and central banks. It also has negative repercussions on settlement organisations, custodian banks, international central securities depositories (ICSDs) and CSDs. Ultimately, this uncertainty makes transactions more expensive, with a knock-on effect on settlement efficiency and liquidity.

Quantification of the economic effects of cross-border legal uncertainty is not a straightforward matter and the methodology can differ, depending on the specific market. Some of the markets to look at include over-the-counter (OTC) derivatives and securities financing transactions, which include repurchase agreements (repos) and securities lending agreements. In these markets, cross-border conflict of laws negatively affects 'good-faith acquisition' of collateral assets. Derivatives, as well as repo and securities lending collateral assets face increased enforcement difficulties in cross-border settings, stemming from different national rules.

Financial instruments used as collateral need to be delivered between the parties, implying a transfer of property from the collateral provider to the collateral taker. In a cross-border situation, there is a higher risk of the transfer being invalid or otherwise defective. In other words, the assumed legal positions might later be challenged in court, either by the insolvency administrator of one of the parties or by a third party claiming to have interests in the securities. If enforcement proves to be impossible or considerably delayed, significant losses may occur, which might provoke the party's insolvency and maybe even have systemic effects, provided others are affected by the same problem. As collateral is often reused in further transactions, it is important that a first defective acquisition does not become the source of a chain of subsequent defective acquisitions of the same collateral assets. Thus, collateral markets heavily rely on 'good faith acquisition' of the subsequent acquirers. At the same time, the concept of good faith acquisition is not covered by the Financial Collateral Directive<sup>111</sup>.

#### *Quantification*

As part of the standard market practice, collateralisation is used as a significant risk management tool to reduce counterparty risk. The magnitude of potential maximum

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<sup>110</sup> For more details, see Guynn, R.D. and Marchand, N.J., *Transfer or Pledge of Securities held through Depositories* in Van Houtte, H. (ed.), *The Law of Cross-Border Securities Transactions*, London, 1999.

<sup>111</sup> Directive 2002/47/EC on financial collateral arrangements.

exposures to legal risk inherent in cross-border conflict of laws situations can thus be gauged by looking at the amount of collateral posted in these markets. Alternatively, data on positions can also be used, since those positions are backed up by collateral assets.

Based on the latest BIS OTC derivatives statistics as at December 2016<sup>112</sup>, the maximum amount exposed to potential cross-border conflict of laws situations in the OTC derivatives space<sup>113</sup> is estimated at EUR 1.4 trillion, which is the net<sup>114</sup> value (i.e. the gross market value after netting) of all cross-border OTC contracts with at least one counterparty from Europe<sup>115</sup>. Some EUR 1.1 trillion is represented by OTC interest rate derivatives (IRDs) and EUR 33 billion by the credit default swaps (CDS) market<sup>116</sup>. To the extent that a considerable share of OTC derivatives transactions are centrally cleared, central clearing counterparties (CCPs) stand on one side of many of these contracts. According to the BIS data as at end of June 2016<sup>117</sup>, 62% of the reported positions in the OTC derivatives markets were against CCPs. Thus, one could approximate the potential maximum gross exposure of CCPs to cross-border conflict of laws risk in this market at EUR 870 billion. At a more detailed level, and according to the more up-to-date BIS data quoted above, 76% of the reported positions in OTC IRDs and 44% of the positions in CDS were centrally cleared as at December 2016. Thus, in these two segments the maximum risk exposure of CCPs to cross-border conflict of laws can be estimated at EUR 800 billion and EUR 14.5 billion, respectively.

Based on the latest ICMA data for Europe as at June 2017<sup>118</sup>, the value of the cash side of the cross-border repo and reverse repo contracts outstanding represented 56.6% of the total, with some EUR 3.4 trillion. The value of cross-border contracts involving at least one euro area counterparty stood at about EUR 1 trillion. Although there is no dedicated data on the netting effects in this market, netting efficiencies in the centrally cleared repo market reach about 70% of the gross exposures. Given that 28% of all outstanding transactions involve a CCP, one can approximate the net value of cross-border repo contracts where a CCP stands on one side at some EUR 285 billion. Thus, one can estimate the maximum amount exposed to potential cross-border conflict of laws situations in the non-central bank repo markets at the combined value of the cash side of cross-border contracts not involving a CCP (72% of EUR 3.4 trillion) and of the net value of centrally cleared cross-border repo contracts (EUR 285 billion), yielding a EUR 2.73 trillion figure.

As the ICMA survey does not cover the repo transactions which are part of the Eurosystem liquidity operations, one should also add in those repo transactions. The ECB statistical data

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<sup>112</sup> See Statistical release, OTC derivatives statistics at end-December 2016, BIS, May 2017.

<sup>113</sup> Covering interest rate, foreign exchange, credit, commodity and equity-linked derivatives.

<sup>114</sup> It is the net position that is collateralised. The share of cross-border contracts in the OTC derivatives markets, which involve at least one counterparty from Europe, was estimated assuming the same proportion of 44% for cross-border transactions as in the CDS market. This figure is very close to the general estimate of 40% for the share of cross-border contracts by EU market participants, and hence credible. E.g. see Paech, P., *Market needs a paradigm – breaking up the thinking on EU securities law*, in *Intermediated Securities* by Conac, P.-H., Segna, U. and Thevenoz, L. (eds.), Cambridge, 2013.

<sup>115</sup> Covering Belgium, France, Germany, Italy, Netherlands, Spain, Sweden, the UK and Switzerland.

<sup>116</sup> Representing 44% of the gross market value of the CDS market internationally.

<sup>117</sup> See Wooldridge, P., *Central clearing predominates in OTC interest rate derivatives markets*, BIS Quarterly Review, 11 December 2016.

<sup>118</sup> See European Repo Market Survey, Number 33 – conducted June 2017, ICMA, October 2017, covering 47 participants based across 14 EU member states. 42 participants were based in 12 euro area countries. The total number of survey participants was 64, 22 of which were foreign affiliates predominantly located in the UK.

as at June 2017<sup>119</sup> shows that additional EUR 453 billion of cross-border collateral (after haircut) was posted to the Eurosystem as part of its liquidity operations.

According to the ISLA securities lending data as at December 2016<sup>120</sup>, there were about EUR 264 billion of government bonds on loan in Europe, as well as some EUR 145 billion of equities. Although there are no figures for cross-border transactions, one would expect that the proportion of 44% used earlier should not be an overstatement of cross-border business in this market segment. Applying this assumption yields a gross risk figure of EUR 180 billion. To date, there is no data on either the share of the market that is centrally cleared or on the netting benefits that can be achieved in this market.

As mentioned previously and in addition to the overall maximum risk exposure estimates provided above, legal uncertainty in cross-border operations have a cost. One estimate puts the additional transaction cost linked to this cross-border legal uncertainty at 22%,<sup>121</sup> which can be combined with EU securities settlement system data provided by the ECB (as at end-2016) and survey-based data obtained by Oxera<sup>122</sup> to obtain an annual cost estimate. This yields an aggregate annual cost estimate of EUR 13 billion, which is due to legal uncertainty in cross-border transactions. Approximately EUR 6 billion of this cost can be attributed to the increased cost of clearing and settlement of cross-border securities transactions, whilst the remaining EUR 7 billion relate to account provision and asset servicing on a cross-border basis. Whether the entire amount or only part of it is attributable to specific legal uncertainty around the applicable law to proprietary aspects of ownership of securities cannot be established with certainty.

In respect of claims not traded on financial markets, theoretically, the magnitude of the problem resulting from the lack of legal certainty as to the law applicable to the third-party effects of assignments of claims in terms of costs could be measured as follows. First, one could count all agreements on assignment of claims concluded by private parties (natural or legal persons) including a cross-border element (for example, parties are located in different States, or the assignment of the claim involves a foreign debtor) within a given period. Second, the value of the assigned claims would have to be calculated. Third, in order to determine the additional costs resulting from the lack of legal certainty, the costs of seeking legal advice on the law applicable or the costs of compliance with all possible laws applicable to the third-party effects of the assignment would have to be determined and multiplied by the number of assignment contracts and the value of the assigned claims. Finally, in order to determine the amount of cross-border assignments which did not take place due to legal uncertainty, a statistical example of natural and legal persons in the EU would have to be asked whether, for example, in the previous five years, they had contemplated an assignment of claims from or to another Member State and, if so, whether they abandoned such transactions because of the additional legal advice/compliance costs inherent in cross-border transactions, because of the legal certainty risks or because of other reasons. To be able to carry out such analysis, the Commission would thus need to have information on the number

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<sup>119</sup> See [https://www.ecb.europa.eu/stats/payment\\_statistics/cross-border\\_collateral/html/coll1.en.html](https://www.ecb.europa.eu/stats/payment_statistics/cross-border_collateral/html/coll1.en.html)

<sup>120</sup> See ISLA Securities Lending Market Report, 6th edition, ISLA, December 2016.

<sup>121</sup> See Paech, P., *Market needs a paradigm – breaking up the thinking on EU securities law*, in *Intermediated Securities* by Conac, P.-H., Segna, U. and Thevenoz, L. (eds.), Cambridge, 2013.

<sup>122</sup> See *Monitoring prices, cost and volumes of trading and post-trading services*, Report prepared for the European Commission by Oxera, London and Brussels, 2011.

and contents of a relevant statistical sample of different types of written and oral assignments of claims concluded by natural and legal persons as well as on the value of the claims assigned, information on which of such claim assignments had a cross-border element, information on the costs of legal advice and/or compliance of such cross-border assignments, and information on the number of cross-border assignments which were not concluded as a result of the additional costs inherent in cross-border transactions or because of the legal uncertainty risk. Obtaining information on these aspects is not possible as this information is not recorded or collected to such extent by any public or private organisation.

## ANNEX 5. EVALUATION OF EXISTING DIRECTIVES

### Section 1 Executive Summary

An ad hoc evaluation of the existing conflict of laws provisions on proprietary aspects of transactions in securities was carried out in line with the requirement of assessing the performance of existing rules when new action is being considered in the same field. This is not a full evaluation of the relevant Directives in the sense of the Better Regulation rules.

The evaluation of specific conflict of laws provisions in the Settlement Finality Directive<sup>123</sup> ('SFD'), Financial Collateral Directive<sup>124</sup> ('FCD'), and Winding up Directive<sup>125</sup> ('WUD') showed that the rules in place do not achieve enough certainty as to which law governs proprietary effects of transactions in securities.

The evaluation showed that the wording of the provisions is not always clear and precise enough. Therefore, the national transpositions of the rules and the interpretations differ across Member States. Whereas it is acceptable to have some leeway to transpose the provisions of a Directive into national law, the final outcome of the transposition reveal that the differences result in possibly different governing laws being applied in practice in different Member States. As the objective was to harmonise the rules determining the governing law, the evaluation concludes that the provisions did not fully achieve their intended results.

### Section 2 Introduction

The SFD, FCD and WUD, hereafter collectively referred to as the 'directives', came into force in 1999, 2003, and 2004. In most Member States, all three Directives have been transposed more than a decade ago. Thus, enough time has passed to allow for an evaluation of the *acquis*.

The first two directives (SFD, FCD) harmonise the substantive law of Member States. Only supplementary, each of the two directives contains a single provision which harmonises the conflict of laws rules of Member States within their restricted scope of application, namely in relation to proprietary rights in book-entry securities when those assets are provided as collateral to/or among specific parties. The third directive (WUD) harmonises the conflict of laws rules of Member States which designate the applicable law in reorganisation and insolvency proceedings of EU credit institutions and investment firms. However, only one conflict of laws rule in the WUD concerns proprietary rights in book-entry securities.

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<sup>123</sup> 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

<sup>124</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements

<sup>125</sup> 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

This evaluation is confined only to the mentioned conflict of laws rules, i.e. Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD. The wording of the conflict of laws rules in the three directives to be evaluated is as follows:

- *“Where securities including rights in securities are provided as collateral security to participants, system operators or to central banks of the Member States or the 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.”* (Article 9(2) SFD);
- *“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”,* where the term ‘relevant account’ is defined as *“the register or account – which may be maintained by the collateral taker – in which the entries are made by which that book entry securities collateral is provided to the collateral taker”* (Article 9(1) and Point (h) of Article 2(1) FCD);
- *“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”* (Article 24 WUD).

An evaluation of the substantive law provisions of the Directives is beyond the scope of this exercise as it has been carried out in the past and the assessment was positive<sup>126</sup>. In contrast, the previous evaluation reports reached a negative conclusion in relation to conflict of laws rules: *“The Commission is of the opinion that there is not a sufficient level of legal certainty at present, neither at the international level nor at Community level. Therefore, also in the event that the Council would decide not to go forward with the [Hague Securities] Convention, Article 9 FCD (as well as Article 9 SFD and Article 24 Winding-up Directive) would still have to be amended to improve the situation within the Community by specifying the exact criteria for determining the relevant location of account”*<sup>127</sup>. However, so far the robustness of this conclusion has not been backed up by a detailed assessment of the performance of the existing conflict of laws acquis.

The objective of this evaluation is to analyse in-depth whether the objective of the directives to provide legal certainty in cross-border securities transactions has been met. The aim of this evaluation is thus to (i) examine how exactly the conflict of laws rules in the directives have been

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<sup>126</sup> See Report from the Commission. Evaluation report on the Settlement Finality Directive 98/26/EC (EU 25), COM(2005)675 final/2 (‘SFD Evaluation Report’); Report from the Commission to the Council and the European Parliament. Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC), COM(2006)833 final (‘FCD Evaluation Report’).

<sup>127</sup> FCD Evaluation Report, p. 11.

transposed by Member States, *(ii)* assess whether problems for market participants arise that stem from transpositions or from differences between transpositions, and *(iii)* identify if and to what extent the conflict of laws rules in the directives provide solutions for legal uncertainty as to the applicable law to third party effects of cross-border transactions in securities.

The results of this evaluation will be used in the context of the CMU Action Plan where legal uncertainty as to securities ownership in cases of cross-border transactions was named as one of the obstacles standing in the way of well-functioning Capital Markets Union<sup>128</sup>.

### Section 3 Background to the initiative

#### Settlement Finality Directive ('SFD')

Before the adoption of the SFD, there was systemic risk inherent in the EU payment and securities settlement systems.

A 'system' is a formal arrangement between big financial institutions based on common rules for the processing, clearing and settlement of payment or securities transactions. This can be (1) a payment system, i.e. a system for the settlement of payment instructions on the basis of which funds between institutions are transferred; (2) a securities settlement system, i.e. a system dedicated to the transfer of financial instruments which is usually operated by a CSD<sup>129</sup>; (3) a clearing system which is operated by a 'central counterparty' (so-called 'CCP')<sup>130</sup> interposing itself between the transaction counterparties in order to assume their rights and obligations. Those systems rely heavily on collateral that is posted to secure the pending obligations of system participants.

Systems have an inclination not only to propagate the risk that one party to a transaction performs its obligation (e.g. delivery of securities) whereas the other does not (e.g. payment), but to amplify it. The inability of one system participant to honour its obligations can trigger a knock on effect leading to the inability of other system participants to honour their obligations. At worst, financial markets as a whole may become gridlocked. This systemic risk was highlighted by the 'Herstatt insolvency' in the 70-ties<sup>131</sup>.

<sup>128</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions 'Action Plan on Building a Capital Markets Union' ('CMU Action Plan'), COM(2015) 468 final, p.23

<sup>129</sup> According to Article 39(1) of Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories ('CSDR'), the authorisation as a CSD under CSDR requires that the CSD is notified as a designated system under the Settlement Finality Directive.

<sup>130</sup> According to Article 17(4) of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ('EMIR'), the authorisation as a CCP under EMIR requires that the CCP is notified as a designated system under the Settlement Finality Directive.

<sup>131</sup> In 1974 a small bank in Germany, Bankhaus Herstatt, was closed in the middle of the day by regulators. That day, a number of banks had released payment of Deutsche Marks to Herstatt in Frankfurt in exchange for US Dollars that were to be delivered in New York. Because of time zone differences, Herstatt ceased operations between the times of the respective payments. The counterparty banks did not receive their Dollar payments. There was a panic as banks rushed to freeze their outgoing payments, and the market ground to a halt. The Herstatt failure caused a string of cascading defaults in a rapid sequence, totalling a loss of over 600 million USD to the international banking sector.

The principal objectives of the SFD were therefore “to reduce the risk associated with participation in securities settlement systems” and to contribute “to the efficient and cost effective operation of cross-border payment and securities settlement arrangements in the Community” (Recital 3). The main way to achieve these objectives was through harmonisation of substantive laws of Member States which disapplied certain rules of national insolvency laws to ensure that (1) payments or securities instructions (called ‘transfer orders’) are settled once they have entered a system, regardless of whether the sending institution has become insolvent or a transfer order has been revoked (so-called ‘settlement finality’) and (2) collateral which is heavily used in those systems to secure the performance of the participants’ obligations is fully enforceable in the collateral provider’s insolvency.

For conflict of laws cases, the objectives of the SFD were to determine “which insolvency law is applicable to the rights and obligations of [...] [a] participant in connection with its participation in a system” (Recital 17) and “to ensure that if the participant, the central bank of a Member State or the future European central bank has a valid and effective collateral security as determined under the law of the Member State where the relevant register, account or centralized deposit system is located, then the validity and enforceability of that collateral security as against that system (and the operator thereof) and against any other person claiming directly or indirectly through it, should be determined solely under the law of that Member State” (Recital 20 of the SFD).

The way to achieve these objectives was through introduction of two conflict of laws rules (Article 8 and Article 9(2) of the SFD):

- First, with regard to rights and obligations of system participants, Article 8 of the SFD stipulates that the applicable law is *the law governing the system*. This law – according to Article 2(a) of the SFD – is the law of a Member State chosen by the participants (whereby participants may choose the law of a Member State in which at least one of them has its head office). The objective of Article 8 of the SFD is to determine beforehand that the system rules and the agreements entered into with a participant from another Member State will, in the event of that participant’s insolvency, be enforceable under the insolvency rules applicable to it.
- Second, with regard to property rights of collateral takers to securities provided as collateral in connection with a designated system or to the ECB/central banks of EEA-States, Article 9(2) of the SFD provides for a specific solution and stipulates that the applicable law is *the law of the Member State where the right of the collateral taker with respect to the securities is legally recorded on a register, account or centralised deposit system*. The objective of Article 9(2) of the SFD is to remove uncertainty as to which law determines the validity and enforceability of collateral, as such uncertainty could stand in the way of the immediate realisation of collateral security in the event a system participant defaults and be thus a factor of systemic risk.

## Financial Collateral Directive ('FCD')

The situation before the adoption of the Financial Collateral Directive was described in the Explanatory Memorandum accompanying the Commission proposal as follows<sup>132</sup>:

*“Participants in the EU market who seek to reduce credit risk through the use of collateral face fifteen different regimes as regards perfection requirements (procedures a collateral taker must follow to ensure the rights to the collateral are good against third parties including a liquidator in the event of bankruptcy). They also are confronted with uncertainties as regards the law applicable to cross-border transfers of book entry securities. They also have to consider the impact of all the different bankruptcy legislations which exist in Member States. Therefore, administrative burdens hamper a cost-effective and integrated EU market and legal uncertainty results in unnecessary systemic risk in the financial markets, there being a higher risk of invalidation of cross-border use of collateral than for domestic use of collateral”.*

As stated in the recitals of the FCD, the aim of the EU intervention was to *“contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services”* (Recital 3). The objective of the directive was *“to improve the legal certainty of financial collateral arrangements”* (Recital 5). The main way to achieve this objective was through harmonisation of substantive laws of Member States which insulated financial collateral from insolvency.

Specifically for conflict of laws cases, the objective of the FCD was *“to create legal certainty regarding the use of such securities held in a cross-border context and used as financial collateral under the scope of this Directive”* by extending 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”* (Recital 7). This should achieve that *“if the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation”* (Recital 8).

The way to achieve this objective was through introduction of a conflict of laws rules (Article 9 of the FCD). Article 9(1) of the FCD provides that *“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”* and the term ‘relevant account’ is defined under Point (h) of Article 2(1) of the FCD as *“the register or account – which may be maintained by the collateral taker – in which the entries are made by which that book entry securities collateral is provided to the collateral taker”*. Article 9(2) of the FCD lists the matters covered by this conflict of laws rule as follows: *“(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*

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<sup>132</sup> Proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements, COM(2001) 168 final, Explanatory Memorandum, p. 3.

*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”.*

### **Winding Up Directive (‘WUD’)**

Before the adoption of the WUD, the insolvency or reorganisation of a bank or investment firm established in one Member State that was operating on a cross-border basis within the Union, in particular through branches in other Member States, raised many legal problems for all parties involved. This is because different Member States approach insolvency from different perspectives. Some jurisdictions are more pro-debtor than others, while some favour judicial rather than administrative procedures for dealing with the insolvency procedures. Some of the problems also included conflict of laws issues, differences of procedure, different treatment of assets, and different approaches to set-off and netting.

As stated in the recitals of the WUD, the aim of the Directive was to guarantee that the reorganisation and insolvency measures adopted by the administrative or judicial authorities of the home Member State of the failing bank or investment firm are effective in all other Member States (Recital 7). The principal objective was to ensure that it is only the authorities of the home Member State which *“have sole jurisdiction”* and that their decisions are *“recognised and [...] capable of producing in all the other Member States, without any formality, the effects ascribed to them by the law of the home Member State, except where this Directive provides otherwise”* (Recital 16). This objective was counterbalanced by the supplementary objective to safeguard *“the confidence of third-party purchasers in the content of the registers or accounts regarding certain assets entered in those registers or accounts”* (Recital 29).

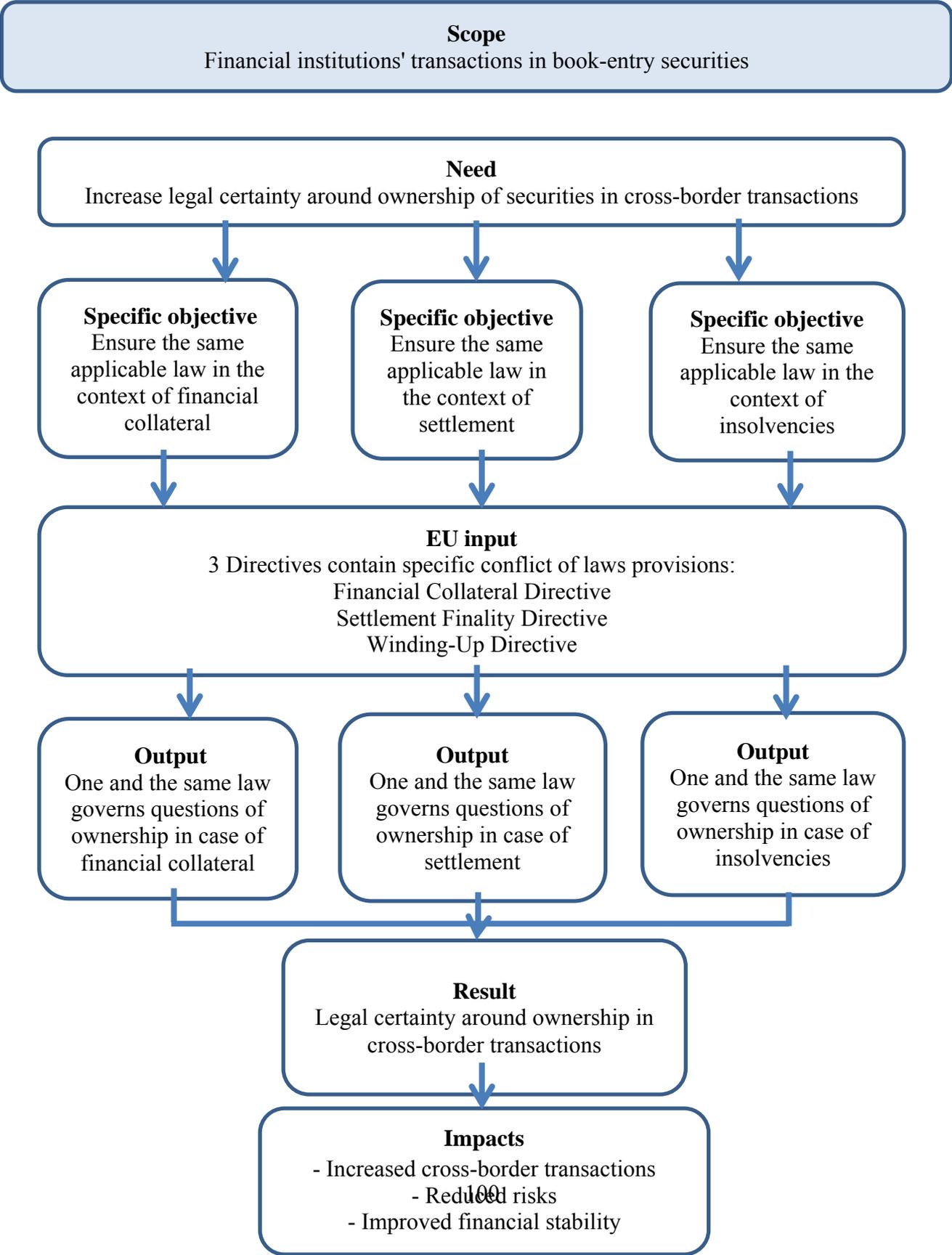
The way to achieve these objectives was through a fully-fledged harmonisation of conflict of laws rules applicable in reorganisation and insolvency of EU credit institutions and investment firms. Although the general conflict of laws rule of the WUD is that it is the law of the home Member State that applies to reorganisation or insolvency measures (Articles 3 and 10 of WUD), a specific conflict of laws rule was designed regarding the enforcement of proprietary rights to financial instruments in the bank's or the investment firm's insolvency. Article 24 of the WUD provides that the applicable law to enforcement of such rights is the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located. As explained in the Council Common Position<sup>133</sup>, the objective of Article 24 of WUD was **to protect “the rights in these securities against the potential negative effects of reorganisation measures or insolvency proceedings opened according to the law of a Member State which is different from the law of the Member State where the register, account or deposit system is held”**.

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<sup>133</sup> Common Position (EC) No 43/2000 adopted by the Council on 17 July 2000 with a view to adopting Directive 2000/.../EC of the European Parliament and of the Council of ... on the reorganisation and winding up of credit institutions, OJ C 300, 20.10.2000, p. 13, p. 29 (see the explanation in relation to Paragraph 1(f)).

The intervention logic below provides a description – in a summarised diagram format – on how the EU conflict of laws rules are expected to work. It is also used to carry out the evaluation and answer specific questions.

**Figure 1: Intervention Logic diagram**



## Section 4 Evaluation Questions

### **Question 1: How effective has the EU intervention been?**

To what extent have the objectives of

a) the SFD to reduce the risk associated with participation in securities settlement systems and to contribute to the efficient and cost effective operation of cross-border payment and securities settlement arrangements, and in particular the objective of Article 9(2) of the SFD to ensure that if the collateral taker has a valid and effective collateral security as determined under the law of the Member State where the relevant register, account or centralized deposit system is located, then the validity and enforceability of that collateral security should be determined solely under the law of that Member State;

b) the FCD to create legal certainty regarding the use of securities held in cross-border context, and in particular the objective of Article 9 of the FCD to ensure that if the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation;

c) the WUD to safeguard the confidence of third-party purchasers in the content of the registers or accounts regarding certain assets entered in those registers or accounts, and in particular the objective of Article 24 of the WUD to protect the property rights in financial instruments against the potential negative effects of reorganisation measures or insolvency proceedings opened according to the law of a Member State which is different from the law of the Member State where the register, account or deposit system is held

been achieved and what factors influenced the achievements observed?

### **Question 2: How efficient has the EU intervention been?**

To what extent have Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD been cost-effective for market participants given the effects they have achieved to provide legal certainty?

### **Question 3: How relevant is the EU intervention?**

To what extent are Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD still relevant more than a decade after they had been introduced and in light of current developments in the financial markets?

### **Question 4: How coherent is the EU intervention internally and with other EU actions?**

To what extent are the evaluated EU conflict of laws rules coherent internally as well as with other pieces of EU conflict of laws legislation, i.e. the Rome I Regulation, the Insolvency Regulation Recast, the Winding Up Directive and the Solvency II Directive, and with other pieces of EU financial legislation, i.e. the Central Securities Depositories Regulation and the Markets in Financial Instruments Directive?

### **Question 5: What is the EU added value of the intervention?**

To what extent have Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD helped to increase legal certainty and to what extent does the legal risk related to cross-border transactions continue to require action at EU level?

#### **Section 5 Method**

This evaluation is primarily based on the feedback received to Commission Questionnaires and public consultations with the stakeholders, findings of the T2S Harmonisation Steering Group, report of the European Post-Trade Forum, i.e. an expert group established by the Commission in 2016 with the task of assessing the evolution of the EU post-trade landscape ('EPTF'), and the discussions with the expert group established by the Commission in 2017 on conflict of laws regarding claims and securities ('Expert Group on conflict of laws').

Particularly, the sources include:

- Non-public responses received to a targeted Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee ('EGESC'), a comitology committee, as well as responses received to a targeted Questionnaire from several members of the EPTF (i.e., from Association for Financial Markets in Europe (AFME), Association of Global Custodians (AGC), European Banking Federation (EBF), European Central Securities Depositories Association (ECSDA), and T2S National User Groups, issued by the Commission on December 9, 2016 with a deadline for responses: January 31, 2017). Both Questionnaires were specifically designed to obtain feedback on how the conflict of laws rules of the directives have been transposed across Member States, as well as on what kind of financial instruments under MiFID II<sup>134</sup> are creditable to securities or other accounts according to the national regimes and/or practices;
- Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group (hereafter 'T2S Fact Finding Exercise'), published on November 10, 2015 regarding a survey issued on specific conflict of laws issues across 21 national markets covered in Target2Securities<sup>135</sup>;

<sup>134</sup> Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ('MiFID')

<sup>135</sup> Conflicts of Laws Issues in T2S Markets - A Fact Finding Exercise by T2S Harmonisation Steering Group [https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item\\_4\\_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3](https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3)

- Report of the European Post-Trade Forum (hereafter ‘EPTF Report’), published on 27 August 2017<sup>136</sup>;
- Feedback<sup>137</sup> received to the public consultation: Building a Capital Markets Union, launched by the Commission on February 18, 2015 and running until May 13, 2015 (hereafter ‘CMU public consultation of 2015’)<sup>138</sup>;
- Feedback<sup>139</sup> received to the public consultation on the conflict of laws rules for third party effects of transactions in claims and securities, launched by the Commission on April 7, 2017 and running until June 30, 2017 (hereafter ‘conflict of laws public consultation of 2017’)<sup>140</sup>;
- Discussions with the members of the Expert Group on conflict of laws regarding claims and securities<sup>141</sup>, which specifically addressed national transpositions of the directives and national conflicts of laws rules or solutions outside the harmonised field.

### *Limitations – robustness of findings*

First, the assessment of the current legal situation raises some methodical challenges. For example, as for the responses to the Questionnaires, some of the respondents did not provide an explicit answer to the question raised instead limiting the answer to a quotation of the national law. In such cases particular responses were assessed individually and subjectively by analysing the quoted laws, thus creating a possibility that the assessment was not entirely correct. Another issue encountered was inconsistency of terminology used among respondents (particularly, ‘Member States’, ‘EU States’, ‘EEA States’ and so on) which also added some level of doubt as to what exactly respondents meant by their answers (NB – this issue was encountered with only regards a specific question on geographical scope of the national law implementing conflicts of laws rules of the Directives (*Figure 11*)).

Second, there is hardly any quantitative/practical evidence available from the market to back up the legal evaluation by economic considerations.

## **Section 6 Implementation state of play (Results)**

<sup>136</sup> The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en)

<sup>137</sup> Responses to the public consultation: Building a Capital Markets Union  
<https://ec.europa.eu/eusurvey/publication/capital-markets-union-2015?language=en>

<sup>138</sup> Public consultation: Building a Capital Markets Union:  
[http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index\\_en.htm](http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm)

<sup>139</sup> Responses to the public consultation on the conflict of laws rules for third party effects of transactions in securities and claims:  
<https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>140</sup> Public consultation on the conflict of laws rules for third party effects of transactions in securities and claims  
[https://ec.europa.eu/info/consultations/public-consultation-conflict-laws-rules-third-party-effects-transactions-securities-and-claims\\_en](https://ec.europa.eu/info/consultations/public-consultation-conflict-laws-rules-third-party-effects-transactions-securities-and-claims_en)

<sup>141</sup> For the agenda and minutes of the meetings of the Expert Group on conflict of laws regarding securities and claims (E03506) please consult the webpage of the Register of Commission Expert Groups available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3506>

The directives have been adopted already some time ago (SFD applicable since 1999, FCD applicable since 2003, and WUD applicable since 2004) and have been transposed in due time by all Member States (Croatia as the newest Member State having done that in 2013) as well as the three EEA states (Norway, Iceland and Liechtenstein) therefore giving a notable time to assess the working of the directives in practice. This section explains how the conflict of laws rules in the directives have been implemented and which problems have been identified.

### **6.1. Unclear location of securities accounts under PRIMA**

Although all three directives use a similar rule that designates as the applicable law the place of the location or maintenance of the relevant securities account (so-called ‘PRIMA’), the solutions in all three directives differ in detail. The wording of the directives leaves open how to determine where the account is ‘located’ (this is the wording used by Article 9(2) of the SFD and Article 24 of the WUD) or ‘maintained’ (this is the wording used by Article 9 of the FCD). The directives do not specify whether ‘location’ means something different than ‘maintenance’ and whether those terms refer to legal or factual connecting factors. This is not self-explanatory, since new technologies mean that the data may be stored in one country, the client relationship managed from another and electronic records accessible through multiple locations.

It is of major practical importance to examine whether Member States have specified in their implementing legislation criteria to be taken into account when determining the country where the securities account is located, and if not, how are those rules applied in practice.

First, the responses given by Member States (Figures 2 and 3) reveal that considerable inconsistencies exist in terms of the national approaches used to determine the relevant account and its location/maintenance.

When transposing Article 9(2) of the SFD and Article 24 of the WUD, most Member States have not provided any additional criteria in legislation that would help determining the country where the register, account or centralised deposit system is located. In addition, the solution applied in practice to fill the gap as well as the legislative solution in two Member States differ considerably.

**Figure 2: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017**

<b>Question 16 and 28: Does your national transposition of Article 9(2) of SFD and Article 24 of WUD specify any criteria to be taken into account when determining the country where the register, account or centralised deposit system is located? If no, how do national case law and/or legal counsel address these issues?</b>		
<b>Summary of Member States Responses:</b>		
<i>Legislative solution</i>	<i>No criteria specified in legislation</i>	<i>Solution applied in practice</i>

DE, EE:  <i>Supervision over the relevant register</i>	AT, BE, BG, CZ, EL, FI, FR, IE, LV, LT, NL, PT, RO, SK, SI, UK	<i>Main establishment of the account provider: BE</i>  <i>Registered office of the CSD: SI</i>  <i>Freedom to specify contractually where the account is located: CZ</i>
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When transposing Article 9 of the FCD, most Member States have also not provided any additional criteria in legislation that would help determining the country where the relevant account is maintained. In those Member States where a legislative solution exists, the connecting factor varies considerably.

**Figure 3: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017**

<b>Question 20:</b>		
<b>Does your national transposition of Article 9 of FCD specify any objective criteria to be taken into account when determining the country where the relevant account is maintained, such as</b>		
<ul style="list-style-type: none"> <li>• the place where the intermediary is incorporated or has its seat,</li> <li>• the place where the intermediary's branch is located, if the account agreement is concluded in the course of the operations of a branch,</li> <li>• the place where the IT platform is located that operates the securities account,</li> <li>• any other?</li> </ul>		
<b>b) Does your national transposition of the FCD leave a complete or partial choice of law possibility when determining the country where the relevant account is maintained. If your law is silent, how do national case law and/or legal counsel address these issues?</b>		
<b>Summary of Member States Responses:</b>		
<i>Legislative solution</i>	<i>No criteria specified in legislation</i>	<i>Solution applied in practice</i>
DE: <i>Supervision over the relevant register</i>  PT: a) <i>Management of CSD;</i> b) <i>Location of entity where the securities are registered or deposited;</i> c) <i>Issuer</i>  SK: <i>Lien register</i>	AT, BE, BG, CZ, EE, FI, FR, GR, IE, LV, LT, NL, RO	<i>Main establishment of the account provider: BE</i>  <i>Place where the account is effectively maintained: AT</i>  <i>Place where the register is kept: EE</i>  <i>Registered office of the CSD: SI</i>  <i>Branch of the account provider: FI</i>  <i>Freedom to specify contractually where the</i>

SI: Register		account is located: CZ, GR, NL, UK  Mix of criteria: FR
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Second, the responses to the T2S Survey provided by the National User Groups (Figure 4) also highlight the heterogeneity of solutions as to the location of the securities account applied in the harmonised field.

**Figure 4: Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group, 10 November 2015, p. 8**

#### Question 2d:

**When your national conflict of laws rules refer to the place of location of the relevant account (PRIMA), register etc., do they refer to any objective criteria to be taken into account to determine the location? Have you experienced difficulties with the issue of location of an account (e.g. account opened in branches)?**

#### Summary of Responses by T2S National User Groups:

##### d) Criteria for determining the PRIMA location

- PT NUG: Portuguese conflict of laws rules establish that the relevant location is not the physical/material location of the securities but the location of the “legal situation of a security” i.e. the location of the management of the CSD and the location of the custodian where the securities are registered/deposited
- Two T2S NUGs (CH, DK) responded that the criteria relevant for determining the location of the relevant account are as per the HSC rules (e.g. “relevant intermediary”)
- NL NUG: Dutch conflict of laws rules do not provide objective criteria for determining the PRIMA location but, merely, guidance on the basis of which to identify the place of maintenance of the relevant account. No practical issues have arisen so far.
- FR NUG: French conflict of laws rules do not provide for any objective criteria to determine the PRIMA location. What this means in practice is that the securities account is located in the country where the custody services are provided.
- Two T2S NUGs (SK, LU) responded that their national law does not define any objective criteria on the basis of which to determine the PRIMA location.
- IT NUG: Italian law refers to the account in which the book entries or annotations are

directly performed in favour of the account holder.

Therefore, one of the main conclusions of the T2S Fact Finding Exercise reads as follows: *“The considerable heterogeneity in the rules and procedures currently followed by the CSDs operating in the EU (and in the future in T2S), and which is largely a function of the different transposition of the Settlement Finality Directive (SFD) and Financial Collateral Directive (FCD) into domestic laws, is identified in the responses as a generator of legal uncertainty and, by implication, as an obstacle to cross-border trade in securities transactions”*<sup>142</sup>. Thus, the Seventh T2S Harmonisation Progress Report of January 2017 lists the “location of securities accounts/conflict of law” as a priority 2 activity for T2S which is *“key for the enhancement of the competitive environment and the efficiency of T2S”*<sup>143</sup>.

Third, most respondents to the conflict of laws public consultation of 2017 (41,03%) confirmed that they were aware of actual or theoretical situations where it was not clear how to apply EU conflict of laws rules or where their application leads to outcomes that are inconsistent<sup>144</sup>. In addition, some of those stakeholders who answered the question in the negative (25,64%) also acknowledged that even if they were not aware of any actual situations, such situations were theoretically possible<sup>145</sup>. The T2S factfindings exercise highlighted that no clear concrete cases have been reported by T2S National User Groups of conflict of laws issues in cross-border settlement.

The risk of a situation where it was not clear how to apply EU conflict of laws rules was illustrated by one stakeholder as follows: *“the parties may proceed on a confident assumption as to where an account is ‘located’ and then discover under the pressure of litigation, when it is too late to remedy the situation, that the “location” of the account was not, in fact, clear once all relevant factors were considered”*<sup>146</sup>.

Another respondent illustrated the situation where the application of EU conflict of laws rules leads to inconsistent outcomes by the example of a Belgian intermediary that has a branch in the Netherlands. Under Belgian law PRIMA is generally understood as referring to the main establishment of the intermediary which usually leads to the application of Belgian substantive law, whereas under Netherlands law PRIMA is understood as referring to the

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<sup>142</sup> Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group [https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item\\_4\\_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3](https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3), p. 3.

<sup>143</sup> See Seventh T2S Harmonisation Progress Report by T2S Advisory Group, 31 January 2017, [http://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/2017-01-31\\_7th\\_T2S\\_Harmonisation\\_Progress\\_Report.pdf](http://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/2017-01-31_7th_T2S_Harmonisation_Progress_Report.pdf), p. 48–49.

<sup>144</sup> See responses to Question 3 of the Consultation Document on the conflict of laws rules for third party effects of transactions in securities and claims, <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>145</sup> For example, see the response of the Federal Government of Germany to Question 3. The Government of Finland who answered Q3 in the affirmative says that they “find it self-evident that there is, at least theoretically, a risk of situations where the EU conflict of laws rules lead to inconsistent outcomes”.

<sup>146</sup> See the response of ISDA to Question 42.

branch, i.e. Netherlands substantive law would be applicable to the Netherlands branch of a Belgian intermediary. However, the respondent also noticed that practitioners did not regard this inconsistency as a problem<sup>147</sup>.

## **6.2. Unclear which is the relevant account under PRIMA**

The SFD and the WUD do not specify which ‘record’ is the relevant one to determine the applicable law in case a book-entry security is recorded simultaneously in several accounts at different levels of the holding chain (both directives refer to a “*register, account or centralised deposit system*”) and each of the securities accounts is located in a different country. The Financial Collateral Directive does not provide full clarity on this issue either, although it defines the ‘relevant account’ (Point (h) of Article 2.1 of the FCD). However, the definition seems circular as it refers to the account in which the entry of the collateral provision has to be made and this very issue depends in turn on national securities law which the conflict of laws rule still needs to determine.

The EPTF highlights these shortcomings of the directives in its Report and concludes that “*the formulation of the conflict of laws provisions of the aforementioned directives is not identical and might create confusion as to the notion of the relevant account. As a result, the law of the relevant account concept itself is not always clear in its application*”<sup>148</sup>.

It is important to examine whether Member States have specified in their implementing legislation that there is only one relevant account or that there are many accounts relevant for conflict of laws purposes, which is(are) the relevant account(s), and if this is not determined by implementing legislation, how this issue is solved in practice.

The responses (Figure 5) reveal that most Member States have left the issue of the ‘relevant account’ open when implementing the directives. Among those Member States which have addressed the question by specifying in implementing legislation the level of the holding chain where the record of the provision of book entry securities collateral has to be made, the adopted solutions vary considerably. Whereas in some Member States there is only one single ‘relevant account’, in other Member States more than one account can be relevant. The level of the account that is deemed relevant differs between EU jurisdictions as well.

***Figure 5: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017***

### **Question 22:**

**Does your national transposition of the FCD specify the level of the holding chain where the record of the provision of book entry securities collateral has to be made, in particular in the scenario where the collateral taker is also the collateral provider’s direct intermediary? If so, please indicate whether the record of the provision has to be**

<sup>147</sup> Response of the Ministry of Finance and Ministry of Security and Justice of the Netherlands to Question 3.

<sup>148</sup> European Post Trade Report, 15<sup>th</sup> May 2017, p. 95–96. The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en)

**made at the level of a CSD, the level of the collateral provider’s direct intermediary, or at any other level of the holding chain. If your law is silent, how do national case law and/or legal counsel address this issue?**

**Summary of Member States Responses:**

<i>Legislative solution</i>	<i>No specification in legislation</i>
<p>BE: <i>All levels are possible</i></p> <p>BG: <i>CSD level in Bulgaria or any intermediary in case of non-residents</i></p> <p>CZ: <i>Only for holding chain of securities under Czech law</i></p> <p>FI, DE: <i>Direct intermediary</i></p> <p>PT: <i>CSD level; b) Intermediary level; c) Issuer level</i></p> <p>SK, SI: <i>CSD level</i></p>	<p>AT, EE, FR, GR, IE, LV, LT, NL, PT, RO, UK</p>

The above responses as well as the feedback received to the conflict of laws public consultation of 2017 suggests that the answer to the question which is the relevant account for the purpose of determining the applicable law does not depend on national transposition in the field of conflict of laws, but rather on the national securities law that determines the holding model.

First, the respondents to the public consultation often point to their national securities law and deduce from the substantive provisions that the relevant account for conflict of laws purposes is either the end-investor account<sup>149</sup> or the account held at CSD level or at the level of the participants of a CSD<sup>150</sup>. Second, most of the stakeholders are of the opinion that problems can be expected if within one Member State the legal relevance of record(s) for conflict of laws purposes does not coincide with the legal relevance of record(s) under national substantive law<sup>151</sup>. For example, one respondent argued that “[u]nless the two rules coincide, there is a risk that a conflict of laws rule will require the application of the substantive law of a Member State to a record when that Member State’s substantive law does not recognize the record. Such a result would create uncertainty as to the outcome of a dispute in the Member State”<sup>152</sup>. Other stakeholders, however, clearly distinguish between the relevance of a record for conflict of laws purposes and for substantive law purposes and do not expect any fractions

<sup>149</sup> Confidential response to the public consultation, Question 5.

<sup>150</sup> Confidential response to the public consultation, Question 5.

<sup>151</sup> See the Responses of Association of Global Custodians, BNY Mellon, City of London Law Society, Comptershare Limited, EuropeanIssuers, German Banking Industry Committee - Die Deutsche Kreditwirtschaft, Majadaking, Federal Government of Germany, Ministry of Finance and Ministry of Security and Justice of the Netherlands, Joanna Benjamin and Ferdisha Snagg to Question 10.

<sup>152</sup> See the Response of Association of Global Custodians - European Focus Committee to Question 10.

in case the relevant account under PRIMA is not aligned with the account that evidences property rights under the substantive law<sup>153</sup>.

Therefore, as highlighted in the Report of the EPTF, this leads to legal uncertainty as to the applicable law to book entry security collateral: “[...] *the connecting factor of Article 9(1) FCD is unclear and has not been interpreted uniformly across Member States. This can result in legal uncertainty in an important case, commonly encountered in post-trade collateral arrangements: where a financial intermediary, such as a clearing member or a custodian providing settlement services, receives securities from its client into an account provided by the intermediary. Depending on the jurisdiction, the question of the identification of the relevant account can lead to different possible answers: (i) the accounts of the collateral taker on the intermediary’s books; (ii) the account where the intermediary’s entitlement to the securities is recorded (such as the next intermediary in a custody chain or the CSD or another set of books) or (iii) the account of the collateral provider*”<sup>154</sup>.

### **6.3. Unclear how many laws apply in the holding chain under PRIMA**

The divergence of views as to whether there is only one single ‘relevant account’ or whether more than one account can be relevant for conflict of laws purposes, translates into the question whether there is a single legal system applicable or whether more governing laws could apply to a given case.

The responses to the T2S Survey provided by the National User Groups (Figure 6) show the heterogeneity of solutions adopted by Member States as to how many laws apply in a holding chain. In a multi-tier holding structure which goes across different Member States this translates into complexity to determine which of the several accounts in a tier – and in consequence which of the several applicable laws – is to be deemed the decisive one and which substantive law prevails in case there are inconsistent solutions as to the merits.

**Figure 6: Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group, 10 November 2015, p. 7–8**

#### **Question 2b:**

**Whether your national conflict of laws rule(s) designates a single law that governs all stages of a securities transfer from the buyer to the seller, or several laws applicable at each level of the holding chain.**

#### **Summary of Responses by T2S National User Groups:**

<sup>153</sup> See the Responses of AFTI, AFME, Association Nationale des Sociétés par Actions, Euroclear SA/NV, French Banking Association, ISDA and Swedish Securities Dealers Association to Question 10.

<sup>154</sup> European Post Trade Report, 15<sup>th</sup> May 2017, p. 76. The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en).

b) Single or several laws covering the holding chain

- PT NUG: Portuguese conflict of laws rules establishes that for securities issued in a CSD, the law applicable is law of the member state where the management of the CSD is located. For other securities registered and deposited but issued in a CSD, it is the law of the place of their initial issuance that will apply.
- Three T2S NUGs (CH, DK, IT) responded that their rules allow the applicability of several conflict of laws rules across the holding chain.
- NL NUG: when the Dutch law is the law applicable, it will cover the whole holding chain, as long as the accounts are held in Netherlands.
- HU NUG: the law covering all stages of the securities transfer is that of the country of the stock exchange where the relevant securities are listed and traded.
- SK NUG: The parties to the agreement whose subject matter is a financial instrument may chose the law governing the contractual relationship of the parties. There is no restriction on choice of law with respect to financial instruments.
- FR NUG: A single law will cover the entire holding chain, and this is the law of the “relevant account”, as per the relevant EU Directives (FCD, SFD, WUD).
- DE NUG: A single law will cover the entire transaction between a seller and a buyer or between pledgor and a pledgee.

In addition, the feedback received to the conflict of laws public consultation of 2017 proves uncertainty as to the operation of PRIMA in the Member States. Already the fact that almost half of the stakeholders have not responded at all to Question 5 of the Consultation Document<sup>155</sup> (asking how do statutory rules, case law and/or legal doctrine in their jurisdiction answer the question which is the relevant ‘record’ for conflict of laws purposes) might suggest that the concept of the relevant record itself is not clear in its application. Some responses expressly confirm that it is unclear<sup>156</sup>.

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<sup>155</sup> Out of 39 respondents to the public consultation 19 respondents (which amounts to 48,71%) have provided no answer to Question 5.

<sup>156</sup> See response of Joanna Benjamin and Ferdisha Snagg to Question 5 and response of Ministry of Finance and Ministry of Security and Justice of the Netherlands to Question 6a.

Moreover, the other half of the stakeholders who provide a response present conflicting views as to how many relevant accounts there are, which is the relevant account and how many laws apply in the holding chain under the existing EU conflict of laws rules<sup>157</sup>.

Most stakeholders are convinced that under PRIMA – as employed by the EU conflict of laws rules – all accounts are relevant in the sense that the applicable law is determined separately for each level of the chain of intermediaries<sup>158</sup>. Some of these respondents also note that the step-by-step approach does not amount to multiple laws being applicable, as *“a collateral taker takes collateral in an account that is maintained and operated in one given legal system”*, so e.g. if collateral is taken in an account in France, only French law applies and there is no need to verify whether requirements of other legal systems are also complied with<sup>159</sup>. However, the same stakeholders acknowledge that *“a conflict arises where an investor from an intermediated holding system invests in securities issued in a transparent holding system. In that case, each system considers the account in its own system to be the ‘relevant account’, although the end investor can’t provide instructions in relation to the account opened at the CSD in the transparent system”*<sup>160</sup>.

Conversely, one bank association is confident that its jurisdiction a step-by-step-approach is not applied and that under its conflict of laws rule it is the account of the end investor that determines the law applicable to the whole transaction, irrespectively of how many countries are involved<sup>161</sup>. This view is, however, expressly rejected by another stakeholder from another jurisdiction who is of the opinion that *“predefining one single applicable law in the chain would completely disregard the legal nature of the chain and we are unclear about how this could actually work in practice”*<sup>162</sup>.

Nevertheless, there seems to be wide agreement that if different substantive laws apply in a cross-border holding chain, they interact smoothly. This view is shared by most stakeholders<sup>163</sup>. However, one stakeholder believes that *“the application of different substantial laws in one cross-border holding chain may create problems in practice especially in cases a ‘securities entitlement’ of ‘trust’ approach is applied”*<sup>164</sup>. Another one noted in a similar vein that *“there might be unsolved legal questions where the substantive laws involved are based on different principles and the conflict of laws rules do not lead to a single*

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<sup>157</sup> See responses to Question 5 and 6 of the Consultation Document on the conflict of laws rules for third party effects of transactions in securities and claims: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>158</sup> See responses of AFTI, and French Banking Federation to Question 3 and 6a; Responses of Association of Global Custodians, BNY Mellon, Euroclear SA/NV to Question 5; Responses of Government of Finland to Question 6a.

<sup>159</sup> See responses of AFTI, and French Banking Federation to Question 5.

<sup>160</sup> See responses of AFTI, and French Banking Federation to Question 6a.

<sup>161</sup> See response of German Banking Industry Committee – Die Deutsche Kreditwirtschaft to Question 5.

<sup>162</sup> Response of Euroclear SA/NV to Question 6.

<sup>163</sup> Responses of AFTI, Association for Financial Markets in Europe, City of London Law Society, Euroclear SA/NV and French Banking Federation to Question 6a.

<sup>164</sup> Response of European Issuers to Question 6a.

*jurisdiction that is applied to all legal questions in respect of the ownership of securities held within that cross-border holding chain*”<sup>165</sup>.

Only three respondents provided concrete examples of practical problems created by different substantive laws being applicable in one cross-border holding chain: 1. floating charges are hampered from operating in an international context<sup>166</sup>; 2. security interests over financial securities outside the scope of the FCD might be subject to different substantive laws which interact less smoothly<sup>167</sup>; 3. different laws might understand differently whether something is a claim or a thing<sup>168</sup>.

Finally, one respondent noted that “[e]ven if we cannot consider specific situations in which the different substantive laws create problems, the variety of substantive laws could cause risks and costs in transactions. Because of the complexity of cross-border holding chains, different safeguards have to be established (‘Drei-Punkte-Erklärung’, general custody terms, legal opinions etc.)”<sup>169</sup>.

#### **6.4. Renvoi**

‘Renvoi’ is a legal technique where a jurisdiction’s conflict of laws rule does not only designate another country’s substantive law to be applicable, but also the other country’s conflict of laws rules, which might refer back to the law of the original jurisdiction or point to another law.

Whereas the Financial Collateral Directive expressly excludes *renvoi* (Sentence 2 of Article 9.1 of the FCD<sup>170</sup>), the other two directives do not. Thus, it is important to check whether Member States have excluded *renvoi* in their implementing legislation, and if not, whether *renvoi* is applied in practice.

The responses to the T2S Survey provided by the National User Groups (Figure 7) show that “substantial variations exist across jurisdictions in terms of the recognition, or otherwise, by their national conflict of laws rules, of the possibility of *renvoi* (i.e. the incorporation, in the national conflict of laws rules, not only of the ordinary (internal) law of a foreign country but, also, of that foreign country’s conflict of laws rules)”<sup>171</sup>.

#### **Figure 7: Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group, 10 November 2015, p. 8**

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<sup>165</sup> Response of German Banking Industry Committee - Die Deutsche Kreditwirtschaft to Question 6b.

<sup>166</sup> Response of Professor Jan H. Dalhuisen to Question 6b.

<sup>167</sup> Response of French Banking Federation to Question 6b.

<sup>168</sup> Confidential response to the public consultation, Question 6b.

<sup>169</sup> Response of the Federal Government of Germany to Question 6b.

<sup>170</sup> Sentence 2 of Article 9.1 of the FCD reads as follows: “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”.

<sup>171</sup> Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group [https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item\\_4\\_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3](https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3), p. 3.

### Question 2c:

**Whether and which of your national conflict of laws rule(s) expressly excludes, or allows the possibility of renvoi (i.e. whether a designation of the law under your national conflict of laws rule includes a foreign conflict of laws rule).**

### Summary of Responses by T2S National User Groups:

#### c) “Renvoi” doctrine

- Six T2S NUGs (PT, CH, DK, NL, IT, SK) responded that their conflict of laws rules expressly exclude renvoi (i.e. i.e. the incorporation, in the national conflict of laws rules, not only of the ordinary (internal) law of a foreign country but, also, of that foreign country’s conflict of laws rules), while another two T2S NUGs (DE, CH) responded that their conflict of laws rules are deemed to exclude, by way of interpretation, the possibility of renvoi.
- Three T2S NUGs (FR, RO, BE) reported that their national conflict of laws rules are deemed to allow, by way of interpretation, the possibility of renvoi.
- LU NUG: If an agreement between the parties is governed by a law other than the law of Luxembourg, and this law allows for renvoi, the law of Luxembourg will allow it.
- One non-T2S NUG (UK) responded that if an agreement between the parties to a securities transaction is governed by a law other than the laws of the UK, and this law allows for renvoi, the laws of the UK law will allow it.

The T2S Fact Finding Exercise concludes that “[t]hese variations inevitably add to legal uncertainty (in terms of the possible application of unforeseen application of foreign legislation in connection with transactions over intermediated securities), despite the fact that Articles 8 and 9 of the SFD are deemed (be it only by way of interpretation), to exclude renvoi”<sup>172</sup>. The EPTF Report also refers to the *renvoi* problem when it highlights the uncertainty as to the legal soundness of risk mitigation techniques used by intermediaries and of CCPs’ default management procedures (EPTF Barrier 8)<sup>173</sup>.

### 6.5. Fragmented legal framework

The conflict of laws rules of the Directives have a restricted scope of application and do not cover all transactions or all counterparties which results in a fragmented legal framework at

<sup>172</sup> Ibid..

<sup>173</sup> See European Post Trade Report, 15th May 2017, The EPTF Report and its Annexes are available at: [https://ec.europa.eu/info/publications/170515-eptf-report\\_en](https://ec.europa.eu/info/publications/170515-eptf-report_en), p. 76, footnote 100.

national level. The three EU conflict of laws rules also vary between themselves when it comes to their material, personal, and geographical scope which adds to the inconsistencies.

The following sections will present the respective scopes of the EU conflict of laws rules in turn and examine how Member States have implemented them, in particular analyse whether national transpositions differ on introducing various scopes as compared with the scopes of the EU rules.

### **6.5.1. Material scope of the EU conflict of laws rules**

#### 6.5.1.1. Directives

The material scope of Article 9(2) of the SFD is limited to book-entry securities provided as collateral in connection with participation in a designated system or in connection with operations of central banks. Given that the notion of ‘securities’ under the SFD refers to the list of ‘financial instruments’ annexed to the Markets in Financial Instruments Directive II<sup>174</sup>, Article 9(2) of the SFD covers all MiFID II financial instruments which are provided as collateral in connection with participation in a settlement system or in connection with operations of central banks.

The material scope of Article 9 of the FCD covers book-entry securities that are provided as collateral, also outside designated systems, but the notion of ‘book-entry securities collateral’ under the FCD is based on a self-standing definition of ‘financial instruments’<sup>175</sup> which covers a different (more restricted) range of assets than the SFD.

The material scope of Article 24 of the WUD is not limited to collateral only, but covers all proprietary rights in financial instruments as defined by MiFID II<sup>176</sup>. However, it covers only one narrow aspect, namely the *effects* of reorganisation measures and winding-up proceedings of a credit institution or an investment firm on the *enforcement* of third parties’ property rights in financial instruments.

#### 6.5.1.2. Transpositions

First, the responses (Figure 8) reveal that most Member States have transposed the material scope of the three conflict of laws rules exactly as stated by the relevant directive. Only few Member States have taken the opportunity to extend the material scope of the rules to cover more transactions. Therefore, in most Member States a fragmented system of conflict of laws rules exists at national level: (1) provisions of EU origin which implement Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD, and (2) purely national conflict of laws rules for transactions falling outside the implementing provisions<sup>177</sup>.

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<sup>174</sup> Article 9(2) in conjunction with point (h) of Article 2 of the SFD. This dynamic reference has to be read as reference to section C of Annex I to Directive 2014/65/EU on markets in financial instruments (‘MiFID II’).

<sup>175</sup> Points (e) and (g) of Article 2(1) of the FCD.

<sup>176</sup> Article 24 in conjunction with indent 11 of Article 2 of the WUD. This dynamic reference has to be read as reference to section C of Annex I to MiFID II.

<sup>177</sup> This does not intend to suggest that there are statutory conflict of laws rules in all those Member States. However, even if there are no statutory provisions in a given Member States for transactions other than

**Figure 8: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017**

<b>Questions 13a, 19a and 26a:</b>		
<b>Is the material scope of your national conflict of laws rule exactly the same as set out in Article 9(2) of SFD, Article 9 of FCD and Article 24 of WUD?</b>		
<b>Summary of Member States Responses:</b>		
	<i>Exactly as stated by the relevant directive</i>	<i>Other</i>
<i>SFD</i>	AT, BG, CZ, EL, IE, LV, LT, NL, PT, RO, SK, SI, UK	<i>Extended:</i> BE, EE, FI, FR, DE
<i>FCD</i>	BE, BG, CZ, EE, EL, IE, LT, NL, PT, RO, SK, SI, UK	<i>Extended:</i> AT, FI, FR, DE
<i>WUD</i>	AT, BE, BG, CZ, EE, FI, FR, IE, LV, LT, NL, PT, RO, SK, SI, UK	–

Second, given that the notion of ‘book-entry securities’ is legally defined the *acquis* as meaning “*financial instruments, the title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary*”<sup>178</sup>, the material scope of EU conflict of laws rules effectively depends upon which assets which are being credited to securities accounts in market practice. Thus, it is useful to examine which financial instruments are being credited by intermediaries to securities accounts in which jurisdictions.

The feedback to the Commission Questionnaires (Figure 9) reveals that there is a notable divergence between Member States concerning the issue which assets can be credited to securities accounts. By way of example, in some Member States certain derivatives contracts are credited to ‘securities accounts’, in others they are rather being evidenced as ‘other records’, e.g. in ‘derivatives accounts’.

**Figure 9: Summary of Responses to Questionnaires developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), to T2S National User Groups via the ECB and to the European Post-Trade Forum**

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those being covered by national implementations of EU conflict of laws rules, but there is a case before that Member State’s court, the judge will need to develop the conflict of laws rule to be able to give the ruling. In that sense, there is no such thing as no national conflict of laws rules in a Member State.

<sup>178</sup> Point (ii) of Article 2(9) of Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

**Question:**

Which financial instruments of those listed in Section C of Annex 1 Directive 2004/39/EC (MiFID I) are being credited by investment firms located in your jurisdiction to a 'securities account' and, if applicable, to other accounts as defined by your national laws?

**Summary of Responses:**

**Black:** Responses received from Member States via the EGESC

**Red:** Responses received from T2S National User Groups

**Green:** Responses received from AGC via EPTF

**Blue:** Responses received from ECSDA via EPTF

	<i>Section C of Annex 1 MiFID I</i>	<i>Securities account</i>	<i>Other account (e.g. derivatives account)</i>
1.	<i>Transferable securities as defined by Article 4(1) point 18:  (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;  (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;  (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;</i>	AT, FR, DE, <b>DE</b> , EL, <b>EL</b> , IE, <b>IE</b> , LT, NL, <b>NL</b> , RO, <b>IT</b> , <b>IT</b> , <b>HU</b> , <b>HU</b> , <b>CY</b> , <b>MT</b>	IE
		AT, BG, EE, FI, <b>FI</b> , FR, DE, <b>DE</b> , EL, <b>EL</b> , IE, LV, LT, NL, <b>NL</b> , PT, <b>PT</b> , RO, SK, <b>SK</b> , SI, <b>SI</b> , <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>IT</b> , <b>IT</b> , <b>HU</b> , <b>HU</b> , <b>PL</b> , <b>PL</b> , <b>CY</b> , <b>MT</b>	EE
		AT, BG, EE, FI, <b>FI</b> , FR, DE, <b>DE</b> , EL, <b>EL</b> , IE, LV, LT, NL, <b>NL</b> , PT, <b>PT</b> , RO, SK, <b>SK</b> , SI, <b>SI</b> , <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>IT</b> , <b>IT</b> , <b>HU</b> , <b>HU</b> , <b>PL</b> , <b>PL</b> , <b>CY</b> , <b>MT</b>	EE
		AT, BG, EE, FI, <b>FI</b> , FR, DE, <b>DE</b> , EL, <b>EL</b> , IE, LV, LT, NL, <b>NL</b> , PT, <b>PT</b> , RO, SK, <b>SK</b> , SI, <b>SI</b> , <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>IT</b> , <b>IT</b> , <b>HU</b> , <b>HU</b> , <b>PL</b> , <b>PL</b> , <b>CY</b> , <b>MT</b>	EE
2.	<i>Money-market instruments</i>	AT, EE, FI, <b>FI</b> , FR, DE, <b>DE</b> , IE, <b>IE</b> , LV, LT, NL, <b>NL</b> , PT, <b>PT</b> , SK, <b>SK</b> , SI, <b>SI</b> , <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>IT</b> , <b>IT</b> , <b>PL</b> , <b>PL</b> , <b>CY</b> , <b>EL</b> , <b>MT</b>	EE, RO, <b>DE</b> , <b>IE</b> , <b>HU</b> , <b>PL</b>
3.	<i>Units in collective investment undertakings</i>	AT, BG, EE, FI, <b>FI</b> , FR, DE, EL, <b>EL</b> , IE, <b>IE</b> , LV, LT, NL, <b>NL</b> , PT, <b>PT</b> , <b>DE</b> , <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>IT</b> , <b>IT</b> , <b>HU</b> , <b>HU</b> , <b>PL</b> , <b>PL</b> , <b>CY</b> , <b>MT</b> , <b>SI</b>	EE, RO, SK, <b>DE</b> , <b>IE</b> , <b>UK</b> , <b>PL</b>
4.	<i>Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or</i>	AT, FI, <b>FI</b> , DE, <b>DE</b> , IE, <b>IE</b> , LV, LT, PT, <b>PT</b> , SI, <b>UK</b> , <b>DK</b> , <b>DK</b> , <b>CY</b> , <b>EL</b> , <b>MT</b>	NL, RO, SK, <b>HU</b> , <b>PL</b>

	<i>financial measures which may be settled physically or in cash</i>		
5.	<i>Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event)</i>	AT, FI, FI, DE, IE, LV, LT, PT, PT, SI, UK, CY, DK, EL, MT	NL, RO, SK, HU, PL
6.	<i>Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF</i>	AT, FI, FI, DE, IE, IE, LV, LT, PT, PT, SI, UK, CY, DK, EL, MT	NL, RO, SK, HU, PL
7.	<i>Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls</i>	AT, FI, FI, DE, IE, IE, LV, LT, PT, PT, SI, UK, CY, DK, EL, MT	NL, RO, SK, HU, PL
8.	<i>Derivative instruments for the transfer of credit risk</i>	AT, FI, FI, FR, DE, IE, IE, LV, LT, PT, PT, SI, UK, CY, DK, EL, MT	NL, RO, SK, HU, PL
9.	<i>Financial contracts for differences</i>	AT, FI, FI, IE, IE, LV, LT, PT, PT, SI, UK, DK, CY, DK, EL, MT	NL, RO, SK, HU, PL
10.	<i>Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls</i>	AT, FI, FI, DE, IE, IE, LV, LT, PT, PT, SI, UK, CY, DK, EL, MT	NL, RO, SK, HU, PL

This translates into a situation where the same financial instrument might be assessed differently across the EU for conflict of law purposes. For example, if a court in Member State A in which an exchange-traded derivatives are credited to securities accounts has to determine the law applicable to third party effects of a transaction, this court will most likely classify this asset a book-entry security and thus determine the applicable law based on the national transposition of the EU conflict of laws rule. However, a court in Member State B where such derivatives are not being credited to securities accounts may consider the very same asset as

being outside the scope of the EU conflict of laws rules and thus determine the law applicable based on purely national conflict of laws rules which might lead to diverging outcomes.

As observed by one respondent to the conflict of laws public consultation of 2017, “[g]iven the possible differences among national laws in terms of defining the kinds of instruments that may be credited to securities accounts and under what circumstances they may be so credited, it is important to have uniform coverage in the conflicts rule”<sup>179</sup>.

## **6.5.2. Personal scope**

### 6.5.2.1. Directives

The personal scope of each of the three EU conflict of laws rules is also different.

The personal scope of Article 9(2) of the SFD is limited to collateral security provided to participants or operators of designated systems or central banks of the EEA States or the ECB.

The personal scope of Article 9 of the FCD is limited to the collateral taker belonging to one of the specified categories of public bodies or financial institutions<sup>180</sup> and the collateral provider either belonging to one of these categories or being a non-financial firm, if the Member State has not excluded such firms from the scope of the FCD<sup>181</sup>.

The personal scope of Article 24 of the WUD is not restricted at all (otherwise than that it applies only in insolvency or reorganisations proceedings of credit institutions or investment firms which is rather a restriction *rationae materiae*).

### 6.5.2.2. Transpositions

As the responses (Figure 10) reveal, most Member States have not extended the personal scope of the EU conflict of laws rules. Only few national transpositions cover more counterparties than the conflict of laws rules set out in the directives. Thus, in most Member States other counterparties, i.e. private investors and consumers, as well as sometimes non-financial firms (in those Member States which have made use of the option in Article 1(3) of the FCD) are also outside the scope and covered by national conflict of laws regimes.

***Figure 10: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017***

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<sup>179</sup> Response of Association of Global Custodians - European Focus Committee to Question 4.

<sup>180</sup> Article 1(2) of the FCSD reads as follows: “The collateral taker and the collateral provider must each belong to one of the following categories: (a) a public authority [...], (b) a central bank, the European central Bank, the Bank for International Settlement, a multilateral development bank [...], the International Monetary Fund and the European Investment Bank; (c) a financial institution subject to financial supervision [...], (d) a central counterparty, settlement agent or clearing house [...], (e) a person other than a natural person, including unincorporated firms and partnerships, provided that the other party is an institution as defined in points (a) to (d)”.

<sup>181</sup> Article 1(3) of the FCSD reads as follows: “Member States may exclude from the scope of this Directive financial collateral arrangements where one of the parties is a person mentioned in paragraph 2(e). [...]”.

**Questions 13a, 19a and 26a:****Is the personal scope of your national conflict of laws rule exactly the same as set out in Article 9(2) of SFD and Article 9 of FCD?****Summary of Member States Responses:**

	<i>Exactly as stated by the relevant directive</i>	<i>Other</i>
<i>SFD</i>	AT, BE, BG, CZ, EL, IE, LV, LT, NL, PT, RO, SK, SI, UK	<i>Extended:</i> DE, EE, FI, FR
<i>FCD</i>	BE, BG, CZ, EE, FR, EL, IE, LV, LT, NL, PT, RO, SK, SI	<i>Extended:</i> AT, DE, FI, UK

**6.5.3. Geographical scope**

## 6.5.3.1. Directives

The geographical scope of the EU conflict of laws rules varies.

The widest scope has Article 9 of the FCD which might designate as applicable law the law of any country in the world (so-called ‘universal scope’). This is because the wording of Article 9(1) refers to “the law of the *country* in which the relevant account is maintained”. Therefore, any law specified by the place of the relevant account is applicable whether or not it is the law of a Member State.

In contrast, Article 9(2) of the SFD and Article 24 of the WUD rules refer to an account being located in ‘Member States’ only. Thus, situations where the account is located in a third state fall outside the geographical scope of both EU conflict of laws rules. Nevertheless, it should be born in mind that both directives have been incorporated into the EEA Agreement by respective decisions of the EEA Joint Committee amending Annex IX (Financial services)<sup>182</sup>. Thus, any reference to ‘Member States’ in those directives incorporates not only the 28 EU Member States but also the EEA States Iceland, Norway and Liechtenstein<sup>183</sup>. Therefore, Article 9(2) of the SFD and Article 24 of the WUD can only designate the law of an EEA State as applicable law. Hence, situations involving account holdings in third countries are outside the scope of both EU conflict of laws rules and thus fall under domestic conflict of laws rules of Member States.

<sup>182</sup> Settlement Finality Directive 98/26/EC was incorporated by Decision of the EEA Joint Committee No 53/1999 of 30 April 1999 amending Annex IX (financial services) to the EEA Agreement; Winding-up Directive 2002/24/EC was incorporated by Decision of the EEA Joint Committee No 167/2002 of 6 December 2002 amending Annex IX (financial services) to the EEA Agreement.

<sup>183</sup> In its judgement of 24 October 2013 in Case C-85/12 (*LBI hf, formerly Landsbanki Islands hf v Kepler Capital Markets SA and Frédéric Giraux*), the Court of Justice of the European Union confirmed that States party to the Agreement on the European Economic Area are treated under the Winding-up Directive in the same way as Member States of the EU.

### 6.5.3.2. Transpositions

The responses (Figure 11) reveal that the transposition of the geographic scope of the EU conflict of laws rules has provided some difficulties. Although most national transpositions have either the same or a wider geographical scope than the EU conflict of laws rules in the directives, some Member States seem to have restricted the geographical scope of their national implementing provisions.

Based on the responses provided by Member States to the Questionnaire, it appears that

- two Member States have transposed Article 9(2) of the SFD (which applies to all EEA States) by restricting its application to situations
  - where the account, register or centralised deposit system is located in the EU Member States (Belgium) or
  - when collateral security is provided to participants, system operators or to central banks of the EU Member States or the ECB (Czech Republic);
- three Member States have transposed Article 9 of the FCD (which has universal scope of application) by restricting its application to EEA States only (Bulgaria, Lithuania, Romania) and two more Member States have implemented it unilaterally by restricting its scope only to situations where
  - the account is located in the territory of the respective Member State (Latvia),
  - the securities are registered in the CSD of the respective Member State (Slovakia);
- four Member States have transposed Article 24 of the WUD (which applies to all EEA States) by restricting its application to situations where “*the register, account, or centralised deposit system in which those rights are recorded is held or located*” in an EU Member State (Ireland, Latvia, Portugal, Slovenia).

**Figure 11: Summary of Responses to Questionnaire developed by the Commission services and addressed to Member States via the Expert Group of the European Securities Committee (EGESC), 31 January 2017**

<b>Questions 13b, 19b and 26b:</b>			
<b>Is the geographical scope of your national conflict of laws rules implementing Article 9(2) of SFD, Article 9 of FCD, and Articles 24 and 31 of WUD universal or is it limited to the law of EEA-States only?</b>			
<b>Summary of Member States Responses:</b>			
	<i>Universal</i>	<i>EEA-States</i>	<i>Other</i>
<i>SFD</i>	EE, FI, DE, LV, NL, SL	AT, BG, FR, EL, IE, LT, PT, RO, SK, UK	<i>EU Member States:</i> BE, CZ
<i>FCD</i>	AT, BE, CZ, EE, FI,	BG, LT, RO	<i>Unilateral:</i>

	FR, DE, EL, IE, PT, SI, UK		LV, SK
<i>WUD</i>	AT, CZ, EE, SK, SI	BE, BG, FI, FR, LT, NL, RO, UK	<i>EU Member States:</i> IE, LV, PT, SI

#### 6.5.4. Unexpected results and "knock-ons"

The above overview confirms that the scope of EU conflict of laws rules effectively varies across the Union depending on national transposition, legal and regulatory requirements as well as market practice in a given Member State. When it comes to the non-harmonised area, few Member States have extended the scope of their national transpositions. Therefore, the framework of most Member States' conflict of laws rules is composed of (i) a harmonised area implementing the Financial Collateral Directive, the Settlement Finality Directive and the Winding-up Directive; and (ii) a non-harmonised area, outside the scope of EU law.

The feedback received to the public consultation on the conflict of laws rules does not allow assessing the concrete impact of this fragmented legal framework on the actual situation of market players. Most stakeholders do not see difficulties due to the dispersal of conflict of laws rules in EU directives and national laws<sup>184</sup>.

Those respondents who acknowledge problems due to the fragmented legal framework, point to the need of more sophisticated legal due diligence and more costs<sup>185</sup>. As explained by one stakeholder, “[i]t is often uneconomic or impractical for transacting parties to comply with the substantive laws of multiple States. Yet, compliance may be prudent because of the risk that a dispute in one forum would lead to the application, under the forum State’s conflict of law rules, of a substantive law different from the substantive law determined if a dispute were in a forum in another State after applying the other State’s conflict of laws rules. However, it is often difficult to identify all of the States in which a dispute is likely to occur, let alone to determine the conflict of laws rules of a forum in each of the States and the resulting applicable substantive law that would be applied by the forum”<sup>186</sup>.

Discussions with the members of the Expert Group on conflict of laws regarding claims and securities have further manifested legal uncertainty resulting from the fragmented conflict of laws frameworks which exists in most Member States<sup>187</sup>. Some of the experts argued that particularly for *property rights* fragmentation of conflict of laws rules is flawed by nature. This is because any competing rights which have *erga omnes* effects need to be assessed on

<sup>184</sup> See the responses of AFTI, Association Nationale des Sociétés par Actions, City of London Law Society, Euroclear SA/NV, European Central Securities Depositories Association, European Issuers to Question 7 of the Consultation Document on the conflict of laws rules for third party effects of transactions in securities and claims: <https://ec.europa.eu/eusurvey/publication/securities-and-claims-2017?surveylanguage=en>

<sup>185</sup> See the response of Joanna Benjamin and Ferdisha Snagg to Question 7.

<sup>186</sup> Response of Association of Global Custodians - European Focus Committee to Question 7.

<sup>187</sup> See minutes of the second meeting of the Expert Group on Conflict of Laws on Securities and Claims, Brussels 15-16.5.2017, Ares(2017)3159733, [http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail\\_groupDetailDoc&id=33452&no=2](http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail_groupDetailDoc&id=33452&no=2), p. 2-3.

the basis of a single substantive law only. If, on the contrary, the law applicable to *property rights* in one and the same asset is determined on the basis of different conflict of laws rules within one jurisdiction depending on the scope of such rules, conflicting results are to be expected. For example, if priority disputes arise between collateral takers covered by different conflict of laws rules entailed in different legal instruments, different substantive laws can become applicable and if they provide for diverging solutions, the priority conflict will remain unsolved.

## Section 7 Answers to the evaluation questions

### Question 1: How effective has the EU intervention been?

#### 7.1. Article 9(2) of the SFD

*To what extent has the objective of the Settlement Finality Directive to reduce the risk associated with participation in securities settlement systems and to contribute to the efficient and cost effective operation of cross-border payment and securities settlement arrangements, and in particular the objective of Article 9(2) of the SFD to ensure that if the collateral taker has a valid and effective collateral security as determined under the law of the Member State where the relevant register, account or centralized deposit system is located, then the validity and enforceability of that collateral security should be determined solely under the law of that Member State been achieved and what factors influenced the achievements observed?*

The evaluation report of the Settlement Finality Directive of 2005 (hereafter ‘SFD evaluation report’) found that “[t]he SFD is functioning well. Member States are overall satisfied with it”<sup>188</sup>. However, there no explicit assessment of Article 9(2) of the SFD has been done by the Commission in this SFD evaluation report<sup>189</sup>.

First, with regard to security collateral provided in connection with participation in a designated system, the conflict of laws public consultation of 2017 provided a positive feedback on the effectiveness of Article 9(2) of the SFD from CSDs who operate designated systems and thus have the inside to assess the functioning of this conflict of laws rule in practice. The European Central Securities Depositories Association (ECSDA) found that “[t]he rules have proved to function well for the CSDs in the past and do not require a change”<sup>190</sup>. By the same token, one of the two ISCDs explained the following: “In spite of the cross-border dimensions of their business, the Euroclear group entities have not experienced

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<sup>188</sup> Report from the Commission. Evaluation report on the Settlement Finality Directive 98/26/EC (EU 25), COM(2005)675 final/2, p. 9.

<sup>189</sup> In terms of conflict of laws, there are only the two following statements to be found in the SFD evaluation report:

P. 9: “Article 8 applies the law of a system to “[...] the rights and obligations arising from, or in connection with, participation in that system”, in the insolvency of a participant. Clarity is suggested as to a possible collision of insolvency laws, where the law of system is different from the law of the Member State where the system is located”;

P. 11: “The Commission may propose legal instruments to increase the efficiency and safety of clearing and settlement services during 2006. Moreover, the outcome of the discussion of the proposal for the Community to sign the Hague Securities Convention may also have to be taken into account”.

<sup>190</sup> Response of ECSDA to Question 8.

*material problems or difficulties in this area. We believe the conflict of law rules related to in rem rights on securities held in EU CSDs are clear and the European legislation in this area is already quite complete as regards CSDs and their legal environment*<sup>191</sup>.

The T2S Survey has also failed to reveal concrete cases of conflict of laws issues in cross-border settlement. This might indicate that Article 9(2) of the SFD is working effectively in practice. However, the T2S Fact Finding Exercise concludes that *“the paucity of concrete cases of conflict of laws concerns arising [...] in the context of [...] transactions over securities held in a T2S-participating CSD is likelier to be attributable to a lack of legal certainty surrounding cross-border trades, which discourage their execution, than it is to be the consequence (or an indication) of a genuine lack of issues to be addressed through legislative or another form of top-down intervention”*<sup>192</sup>.

Second, with regard to security collateral provided in connection with central bank transactions, neither of the sources collected for this evaluation supplied any proximate evidence on the effectiveness of Article 9(2) of the SFD. Nevertheless, in its response to the CMU public consultation of 2015 the European Central Bank voiced the following opinion: *“As the ECB has stated on earlier occasions, a single conflict of laws rule for financial instrument holdings is required. In cross-border collateral transactions it is of vital importance to ensure that there is legal certainty with regard to the law that governs the validity of the collateral and the rights flowing therefrom. Currently, the place of relevant intermediary approach (PRIMA) is the rule applied in the FCD and SFD. However, this approach only covers certain aspects and a single conflict of laws rule would be welcomed. Thus, the introduction of a clarified connecting factor would be desirable to increase the legal certainty”*<sup>193</sup>. Thus, one could derive from this ECB response that the current limited scope of Article 9(2) of the SFD is not beneficial for legal enforceability of central bank collateral.

Third, as evidenced by Section 6 of this evaluation, the positive achievements of Article 9(2) of the SFD are diminished by at least the following factors:

1. the wording of the provision (*“Where [...] right [...] 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”*) raises a number of interpretative questions, i.e. where the account is located (see Point 6.1.), whether it is the *“register, account or centralised deposit system”* that is relevant for determining the applicable law (see Point 6.2.) and how many laws might apply to one case (see Point 6.3.);

2. the provision of the directive does not expressly exclude *renvoi* (see Point 6.4.);

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<sup>191</sup> Response of Euroclear to Question 7.

<sup>192</sup> Conflicts of Laws Issues in T2S Markets - A Fact Finding Exercise by T2S Harmonisation Steering Group [https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item\\_4\\_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3](https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3), p. 3.

<sup>193</sup> See European Central Bank, *Building a Capital Markets Union – Eurosystem contribution to the European Commission’s Green Paper*, p. 24, available at: [https://www.ecb.europa.eu/pub/pdf/other/150521\\_eurosystem\\_contribution\\_to\\_green\\_paper\\_-\\_building\\_a\\_cmuen.pdf](https://www.ecb.europa.eu/pub/pdf/other/150521_eurosystem_contribution_to_green_paper_-_building_a_cmuen.pdf)

3. the geographical scope of Article 9(2) of the SFD is limited to EEA States only and therefore conflict of laws issued related to collateral accounts maintained in third countries are not covered by EU law but left to national conflict of laws rules; there are also some Member States which have even further restricted the scope in their national transpositions (see Point 6.5.).

Thus, although Article 9(2) of the SFD has greatly enhanced legal certainty as compared to the situation before its enactment when in all jurisdictions national conflict of laws rules were silent on book-entry security collateral, Article 9(2) has not completely eliminated legal risk in designated systems and central bank transactions. Due to the factors mentioned above as well as the diverging transpositions across the EU, the possibility exists that courts in different Member States, if addressed with the very same case, might still answer differently the question which is the law applicable to collateral security provided in connection with a designated system or in EEA central bank transactions.

Therefore, the objective of Article 9(2) of the SFD to ensure that the collateral taker has a valid and effective collateral security under the law determined solely by the law where the relevant securities account is located may not be achieved in certain cases. Thus, the objective of the Settlement Finality Directive to reduce the risk associated with participation in securities settlement systems and to contribute to the efficient and cost effective operation of cross-border payment and securities settlement arrangements has been achieved only partly when it comes to conflict of laws issues. Thus, the examined EU intervention in shape of Article 9(2) of the SFD has been effective only partly.

## **7.2. Article 9 of the FCD**

*To what extent has the objective of the Financial Collateral Directive to create legal certainty regarding the use of securities held in cross-border context, and in particular the objective of Article 9 of the FCD to ensure that if the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation been achieved and what factors influenced the achievements observed?*

The evaluation report of the Financial Collateral Directive of 2006 (hereafter ‘FCD evaluation report’) found that *“the FCD has made it easier to use financial collateral in the European financial market and that it has simplified and made considerably more efficient the procedures for doing so”*<sup>194</sup>. However, the FCD evaluation report also pointed out the weakness of Article 9 of the FCD which was lacking exact criteria for determining the relevant location of account<sup>195</sup>. The FCD evaluation report therefore concluded the following: *“Conflicts-of-law regime: Amend Article 9 FCD (as well as Article 9 (2) SFD and Article 24 Winding-up Directive), either as a consequence of a Council Decision to sign the Hague Securities Convention or (in case the latter would not occur) in order to specify the exact*

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<sup>194</sup> Report from the Commission to the Council and the European Parliament. Evaluation report on the Financial Collateral Arrangements Directive (2002/47/EC), COM(2006)833 final

<sup>195</sup> See FCD Evaluation Report, p. 11.

*criteria for determining the location of account*”<sup>196</sup>. This conclusion, however, has so far not been put into action.

Section 6 of this evaluation has confirmed that different interpretations of the ‘place where the relevant account is maintained’ under Article 9 of the FCD exist and, as a consequence, different transpositions across the EU cause problems of legal certainty (see Point 6.1.). This evaluation has also revealed the following other factors that deteriorated the achievements of Article 9 of the FCD:

1. the wording of the provision (“*the law of the country in which the relevant account is maintained*”) and the definition of ‘*relevant account*’ under the FCD (“*the register or account – which may be maintained by the collateral taker – in which the entries are made by which that book entry securities collateral is provided to the collateral taker*”) allow for different interpretations of the issue which is the relevant account (see Point 6.2.) and how many laws might apply to a case (see Point 6.3.);

2. the fragmentation of the conflict of laws regime at national level causes risks which might negatively influence the application of the national transposition of Article 9 of the FCD itself; in addition, there are some Member States which have restricted the scope of their national transpositions (see Points 6.5. and 6.6.).

Some respondents to the conflict of laws public consultation of 2017 stress that the Financial Collateral Directive “*brought a leap forward in legal certainty in cross border collateral transactions*”<sup>197</sup>. However, they base their assessment rather on the positive effects achieved by the directive on substantive law harmonisation<sup>198</sup>. When it comes to conflict of laws, a respondent voiced the opinion that “*for collateral arrangements entered into under the FCD, the application of the PRIMA principle may not always be entirely clear and, for other collateral arrangements, there may not be any express conflict of law rule (as is the case in France)*”<sup>199</sup>.

Although Article 9 of the FCD has enhanced legal certainty as to the law applicable to book-entry securities collateral provided outside designated systems or central bank transactions as compared to the situation before its enactment when no statutory conflict of laws rules existed in most Member States, it does not guarantee certainty about applicable law in all cases. As highlighted in the response to the CMU public consultation of 2015 by the Contact group on euro securities infrastructures which consists of representatives of members of the Eurosystem, market infrastructures and participants active in the field of collateral management, “[c]lear and consistent rules are needed **across account providers (and in particular intermediaries in collateral chains)** as to which law applies to cross-border

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<sup>196</sup> FCD Evaluation Report, p. 12.

<sup>197</sup> Response of AFTI to Question 1.

<sup>198</sup> AFTI elaborates on its view as follows: „*Before the Financial Collateral Directive, it was as good as impossible to take financial collateral in several European jurisdictions, including of the major financial markets of the EU. Namely by removing formal requirements, allowing substitutions and permitting enforcement through close out netting, the FCD made it possible to take financial collateral throughout the European Union in any securities account maintained in any Member State*”.

<sup>199</sup> Response of French Banking Federation to Question 1.

*transfers of securities and the provision of collateral. A single conflict of laws rule would be beneficial in relation to the holding, acquisition and disposition of securities/collateral*<sup>200</sup>.

To sum up, the objective of Article 9 of the FCD to ensure that the validity against any competing right and the enforceability of book-entry securities collateral is being determined solely by the law designated by PRIMA may not be achieved in certain cases. Due to the factors mentioned above as well as the diverging transpositions across the EU, the possibility exists that courts in different Member States, if addressed with the very same case, will still answer differently the question which is the law applicable to book-entry securities collateral. Given that the collateral taker usually does not know in which Member State's courts will the creditors of the collateral provider try to reach the securities, the objective of the Financial Collateral Directive to create legal certainty regarding the use of securities held in cross-border context has been achieved only partly due to potential conflict of laws issues. Thus, the examined EU intervention in shape of Article 9 of the FCD has been effective only partly.

### **7.3. Article 24 of the WUD**

*To what extent has the objective of the Winding Up Directive to safeguard the confidence of third-party purchasers in the content of the registers or accounts regarding certain assets entered in those registers or accounts, and in particular the objective of Article 24 of the WUD to protect the property rights in financial instruments against the potential negative effects of reorganisation measures or insolvency proceedings opened according to the law of a Member State which is different from the law of the Member State where the register, account or deposit system is held been achieved and what factors influenced the achievements observed?*

So far, the Winding Up Directive has not been subject to a specific evaluation report by the Commission. Nevertheless, the FCD evaluation report mentioned Article 24 of the WUD as a provision to be amended in future *“to improve the situation within the Community by specifying the exact criteria for determining the relevant location of account”*<sup>201</sup>. Thus, the Commission already in 2006 implicitly recognised that the wording of the provision (*“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”*) raises interpretative questions, i.e. where the account is located (see Point 6.1.).

The achievements of Article 24 of the WUD are further diminished by similar factors as those relating to the two other EU conflict of laws rules:

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<sup>200</sup> See COGESI Contribution for CMU on collateral management services (CMS) in response to Question 27 of the Commission's Green paper on building a Capital Markets Union (*“What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?”*), p. 3, available at: [https://www.ecb.europa.eu/paym/groups/pdf/cogesi/contribution\\_for\\_CMU\\_on\\_coll\\_mgmt\\_services.pdf?49f0ca7dc9d354fed908d7dd2ef4f224](https://www.ecb.europa.eu/paym/groups/pdf/cogesi/contribution_for_CMU_on_coll_mgmt_services.pdf?49f0ca7dc9d354fed908d7dd2ef4f224)

<sup>201</sup> FCD Evaluation Report, p. 11.

1. it is unclear whether it is the “*register, account or centralised deposit system*” that is relevant for determining the applicable law in a multi-tier account holding structure (see Point 6.2.) and how many substantive laws might apply to one case (see Point 6.3.);
2. the provision of the directive does not expressly exclude *renvoi* (see Point 6.4.);
3. the material scope of the provision might be interpreted differently across jurisdictions, depending on which assets are credited to a securities account, and some Member States have restricted the geographical scope of Article 24 WUD in their national transpositions (see Point 6.5.).

It should, however, be also noted that, as compared to the two other EU conflict of laws rules, Article 24 of the WUD fulfils a different function. Whereas Article 9(2) of the SFD and Article 9 of the FCD are to be characterised as ‘general’ conflict of laws rules which designate the law governing the creation and effectiveness of property rights over financial instruments (i.e. they allow the counterparties to identify the applicable law under which they can validly create and acquire proprietary rights that can be enforced if the collateral provider defaults pre-insolvency), Article 24 of the WUD is a pure ‘insolvency conflict of laws rule’ which deals only with the *effects* of reorganisation measures and winding up proceedings (hereafter referred to commonly as ‘insolvency proceedings’<sup>202</sup>) upon the proprietary rights. In other words, the aim of Article 24 WUD is to clarify that, in case of insolvency proceedings opened in respect of a credit institution or investment firm, the enforcement of proprietary rights over financial instruments located in another EEA State is governed by the law of this latter EEA State and not by the law of the resolution authorities or the insolvency court. So, for instance, if there is a stay (or moratorium), this is subject to the law of the “*register, account or centralised deposit system*”, and not to the law of the home EEA State (as the general rules of Articles 3(2) and 10(1) of the WUD provide). Article 24 of the WUD, however, does not establish a ‘general conflict of laws rule’ that would apply also outside restructuring or winding-up scenarios.

This difference between the conflict of laws rules has also a bearing on their assessment. Parties always need to know the law designated by the ‘general conflict of laws rules’, i.e. Article 9(2) of the SFD and Article 9 of the FCD, in order to be able to validly create the security collateral (i.e. to complete the steps specified by the applicable substantive law which are necessary to render a collateral arrangement and the provision of collateral effective against third parties). Thus, if parties cannot be absolutely sure about which is the substantive law they need to comply with, the risk to the transaction is essential. Article 24 of the WUD, however, comes into play rather rarely, namely only in cases where the credit institution or investment firm enters insolvency. Thus, it could be argued that the above listed drawbacks weight in practice somewhat heavier in case of Article 9(2) of the SFD and Article 9 of the FCD than in case of Article 24 of the WUD which is applied only in a rather extreme situation.

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<sup>202</sup> This is the concept used by the Settlement Finality Directive. See Point (j) of Article 2 of the SFD which defines ‘*insolvency proceedings*’ as „*any collective measure provided for in the law of a Member State, or a third country, either to wind up the participant or to reorganise it, where such measure involves the suspending of, or imposing limitations on, transfers or payments*”.

If, however, such an insolvency situation arises, then it becomes essential that there are no doubts how to apply Article 24 of the WUD. If there are a number of interpretative questions in an insolvency scenario, then the objective of the Winding Up Directive to safeguard the confidence of third-party purchasers (e.g. collateral takers) in the content of the registers or accounts regarding certain assets (e.g. collateral security) entered in those registers or accounts might not be fully achieved. This is because the risk exists that collateral takers will retrospectively learn that their assets are deemed to be located in another jurisdiction (other than the jurisdiction they have relied upon when they created the collateral security and probably other than the insolvency law). If the enforcement of their property rights has to occur according to that unforeseen law, there may also be unforeseen consequences.

Thus, although Article 24 of the WUD has greatly improved the protection of property rights in financial instruments against the potential negative effects of foreign insolvency proceedings as compared to the situation before its enactment, the Winding Up Directive has also introduced automatic recognition of foreign insolvency proceedings which might bear significant legal risks for collateral takers and investors. As a result, the examined EU intervention in shape of Article 24 of the WUD has been only partly effective.

## **Question 2: How efficient has the EU intervention been?**

*To what extent have Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD been cost-effective for market participants given the effects they have achieved to provide legal certainty?*

There is only a very limited amount of quantitative evidence available to carry out the evaluation of the efficiency of the EU intervention. Neither of the sources used for the evaluation listed in Section 5 provided any data on cost-savings or cost-burdens for market participants resulting from the operation of the EU conflict of laws rules.

What seems clear is that this EU intervention has not caused any increase of costs for market participants. This is because any introduction of EU-wide conflict of laws rules – unlike some regulatory requirements – is not able to add *per se* compliance cost on financial industry, but it can produce only costs savings for those market participants that engage in cross-border dealings, if the EU intervention is effective in increasing legal certainty. It could be otherwise only if the newly introduced EU conflict of laws rules were to fundamentally alter existing and well-established domestic conflict of laws rules which was not the case when Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD were adopted. The introduced EU conflict of law rules, even if based on the innovative PRIMA concept, in fact merely rendered the *lex rei sitae* rule – traditionally applicable to property rights in tangible assets – more precise in case of book-entry securities.

One indicator of costs-efficiency of the EU intervention could be the amount of fees related to specialised legal advice required to determine the applicable law in cross-border cases. It seems clear that if parties need to seek advice of a specialised lawyer to investigate both national and foreign conflict of laws rules and the investigation may involve several jurisdictions, the costs will be higher than if they had to investigate only one set of conflict of laws rules. However, neither the EPTF Report nor the conflict of laws public consultation of 2017 provided any concrete data on the increased costs of such multiplied legal advice.

Nevertheless, the EPTF Report attests that due to residual legal uncertainty as to the applicable law to certain ownership aspects of dealings in securities (EPTF Barrier 11), *“the cost of cross-border transactions is raised, because investors considering a potential transaction (and their intermediaries) find that due diligence is harder, the risk of litigation higher, and the search for certainty elusive. Therefore, the execution of cross-border security transactions often requires costly and extensive legal opinions”*<sup>203</sup>.

Some respondents to the conflict of laws public consultation of 2017 endorse this finding. For example, one respondent explains that *“it is cumbersome and costly to have legal opinions in a cross-border context. Usually a law firm only will produce a legal opinion regarding one national law (basic assumption) and you have to complement that opinion with one or two more legal opinion depending on the cross-border situation. There is a clear lack of legal certainty and stability regarding conflict of laws questions”*<sup>204</sup>. Another stakeholder gives the following example of a conflict of laws opinion: *“Assume that Customer, located in State A, maintains securities in an account at Bank, located in State B. Bank obtains a security right in the securities to secure obligations owed by Customer to Bank, and obtains priority for that security right by complying with the rules of State B. However, Bank does not know if creditors of Customer will try to reach the securities by using judicial process in State A or whether an insolvency administrator in State A will recognize Bank’s security right. Accordingly, Bank often will obtain a legal opinion from counsel in State A that the conflict of laws rules in State A would point to the laws of State B on priority. If the conflict of laws rule in Country A point to the law of State A or to some State other than State B, then Bank will need to consider obtaining priority for the security right under the laws of State A or the other applicable State. **The need for the legal opinion would be significantly reduced if it were transparent that States A and B had the same conflicts of law rule that pointed to the same applicable law.** In that case, whether a dispute is heard in a forum in State A or in State B, the law applied by the forum would be the same”*<sup>205</sup>.

Another indicator of cost-efficiency of the EU intervention could be the foregone gains resulting out of avoidance of cross-border activity by market participants who try to eliminate the residual legal uncertainty. As evidenced by the EPTF Report<sup>206</sup>, the feedback to the conflict of laws public consultation of 2017<sup>207</sup> and the T2S Fact Finding Exercise<sup>208</sup>, market participants are sometimes disincentivised from developing certain cross-border economic activity because of the legal risk. As explained by one stakeholder, *“[i]f there is uncertainty regarding which laws should have applied when taking collateral by way of a security interest, there will be uncertainty whether the security taken has followed the correct procedures and laws, and thus whether such security is effective. This can affect the relevant parties’ ability to take, hold, transfer or otherwise dispose of the relevant assets or security if necessary to protect their commercial and contractual interests. [...] If there is uncertainty in adopting these approaches, the parties may seek to restrict the scope of the transaction so as*

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<sup>203</sup> EPTF Report, p. 97.

<sup>204</sup> Response of the Swedish Securities Dealers Association to Question 1.

<sup>205</sup> Response of Association of Global Custodians - European Focus Committee to Question 1, p. 2.

<sup>206</sup> EPTF Report, p. 98.

<sup>207</sup> Confidential responses to the public consultation, Question 1.

<sup>208</sup> Conflicts of Laws Issues in T2S Markets – A Fact Finding Exercise by T2S Harmonisation Steering Group [https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item\\_4\\_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3](https://www.ecb.europa.eu/paym/t2s/progress/pdf/ag/mtg29/item_4_20151116.pdf?7d32b%208e9f88a6823fd9dd%2061650d3de3), p. 3.

to avoid or mitigate those uncertainties, rather than carry out extensive conflict of laws analysis”<sup>209</sup>. However, as observed by the EPTF Report, the level of such avoidance of cross-border activity “is almost impossible to measure”<sup>210</sup>.

It seems that the EU conflict of laws rules have been cost-effective for market participants to the extent allowed by the form of the legal instrument in which they are enshrined (i.e. directive). Given the limitations of a directive with regard to unification of laws, the objective of the EU intervention has been achieved to a large extent at a low expense to all the parties involved. However, the EU intervention could be more efficient, if the rules were less ambiguous, enshrined in the form of a regulation and uniformly applied across the EU. This would result in cost savings related to specialised legal advice as it would be no longer necessary to identify all the Member States in which a dispute is likely to occur, to determine the conflict of laws rules of each Member State in which judicial proceedings are likely to occur and to examine the substantive laws that would be applied by the different fora.

### **Question 3: How relevant is the EU intervention?**

*To what extent are Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD still relevant more than a decade after they had been introduced and in light of current developments in the financial markets?*

The evaluated conflict of laws rules are still very relevant because legal certainty as to the law applicable to property rights over book-entry securities is more important than ever.

First, this is because of the raise in cross-border securities transactions. As estimated recently by an academic, „[c]ross-border investment and collateralization had, of course, always existed. However, now the share of transactions with a cross-jurisdictional element rose to 40 per cent or more”<sup>211</sup>.

Second, since the financial crisis, collateral in the form of book-entry securities has become vital to the financial system. One respondent to the public consultation of 2017 elaborated on the question of relevance of the EU conflict of laws rules as follows: “*This issue is becoming increasingly important. Two pillars of post financial crisis regulatory reform have been the expansion of clearing and the imposition of mandatory margining requirements for uncleared*

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<sup>209</sup> Response of Association for Financial Markets in Europe to Question 1.

<sup>210</sup> EPTF Report, p. 98.

<sup>211</sup> P. Paech, *Securities, intermediation and the blockchain: an inevitable choice between liquidity and legal certainty?*, Unif. L. Rev., Vol. 21, 2016, p. 621, with the following elaboration in footnote 48: „Data shows that between 5 per cent and 95 per cent of investments in the different European financial centres are allocated to cross-border securities; typically, in large financial centres like London, Frankfurt, and Paris, between 30 per cent and 70 per cent are allocated to cross-border holdings. The share of cross-border holdings is mirrored by a correspondent percentage of cross-border trading activity. Data extracted from Oxera, ‘Monitoring Prices, Cost and Volumes of Trading and Post-Trading Services,’ Report prepared for the European Commission, London and Brussels (2011) 73. Although the data itself relates to equity investments, the authors note, that they have found a positive correlation between equity and debt securities in respect of cross-border holdings). No data is available indicating the percentage of securities collateral provided across borders but, going by the aforementioned figures, a significant percentage may be assumed. It is probably justified, therefore, for ease of reference, to collapse these three elements into the figure of 40 per cent of all holding, trading, and collateral operations by EU market participants in one way or another imply a cross-jurisdictional element”.

*transactions. The ability to take effective security is the foundation on which those pillars are built. CCPs are "safe" because they collateralise their exposures. Uncleared exposure margining requires effective collateralisation. As well as giving rise to a risk of challenge, uncertainties about whether collateralisation or assignments are effective may have wide-ranging consequences, as market participants rely on effective collateralisation in a variety of situations, including those set out in the Additional Information filed alongside this response*"<sup>212</sup>.

With rising collateral scarcity, there is a growing demand to ensure that all eligible book-entry securities are made available to be used as collateral to all its counterparties, regardless of where the assets or the counterparty are situated. Therefore it is increasingly important to guarantee that securities collateral provided on a cross-border basis is legally safe and available to be enforced when the counterparty defaults. Thus, current developments in the financial markets have only increased the relevance of Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD.

#### **Question 4: How coherent is the EU intervention internally and with other EU actions?**

*To what extent are the evaluated EU conflict of laws rules coherent internally as well as with other pieces of EU conflict of laws legislation, such as the Rome I Regulation, the Insolvency Regulation Recast, the Winding Up Directive and the Solvency II Directive, and with other pieces of EU financial legislation, such as the Central Securities Depositories Regulation and the Markets in Financial Instruments Directive?*

First, on internal coherence between Article 9(2) of the SFD, Article 9 of the FCD and 24 of the WUD, it has already been pointed throughout this evaluation that the current EU framework is incoherent. In fact, the different wording of the conflict of laws rules set out in the directives and their limited scope, the diverging transpositions as well as the dispersal of conflict of laws rules between EU law and domestic law are a very significant reason why there is still residual legal risk and, in consequence, why the EU intervention has proved not so effective and efficient as it could be.

Second, on external coherence between this EU intervention and other EU actions, the conflict of laws rules are related to other pieces of EU legislation which also contain conflict of laws rules relating to securities, namely the Rome I Regulation<sup>213</sup>, the Insolvency Regulation Recast<sup>214</sup>, the Winding Up Directive and the Solvency II Directive<sup>215</sup>:

- Article 9(2) of the SFD and Article 9 of the FCD are related to the Rome I Regulation in that there are some uncertainties which rights fall within the scopes of which conflict of laws rules:

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<sup>212</sup> Response of Association for Financial Markets in Europe to Question 1.

<sup>213</sup> Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I)

<sup>214</sup> Regulation (EU) 2015/848 on insolvency proceedings (recast)

<sup>215</sup> Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

- (1) it is unclear whether Article 9(2) of the SFD covers only proprietary or also contractual aspects of collateral arrangements. A systematic interpretation militates in favour of the exclusion of contractual rights, since they are subject to the conflict of laws rules of the Rome I Regulation. However, Recital 31 of the Rome I Regulation may be used as an argument that Article 9(2) of the SFD covers also contractual aspects of dealings in securities;
- (2) there are some issues with ‘characterisation’ (i.e. the process of assigning each component element of a case to the most appropriate juridical category in order to find a relevant conflict of laws rule) with respect to certain types of assets which could be characterised both as ‘book-entry securities’ or as ‘claims’. There is also some debate as to whether Article 14 of the Rome I Regulation already contains rules relating to third party effects of the assignment of claims. If this view is followed, then the problem of an overlap with Article 9(2) of the SFD and Article 9 of the FCD arises for some assets.

Both issues would benefit from an explicit clarification.

- Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD are linked to other ‘insolvency conflict of laws rules’ which protect third-party purchasers of securities after the opening of insolvency proceedings of a corporate (Article 17 of the Insolvency Regulation<sup>216</sup>) reorganisation or winding-up proceedings of a credit institution or investment firm (Article 31 of the WUD<sup>217</sup>) or reorganisation or winding-up proceedings of an insurance undertaking (Article 291 of Solvency II<sup>218</sup>). The three insolvency conflict of laws rules refer to the law of the Member State under the authority of which the register, account or deposit system is kept. Given the similarity of their wording to the EU conflict of laws rules on one hand, but a different formulation of the connecting factor on the other (‘Member State under the authority of which the account is kept’ instead of ‘place of location/maintenance of the account’), there is lack of coherence within the *acquis* which might lead to interpretation problems. Thus, the wording of all mentioned rules could be aligned.

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<sup>216</sup> Article 17 of Insolvency Regulation reads as follows: “Where, by an act concluded after the opening of insolvency proceedings, a debtor disposes, for consideration, of: (a) an immoveable asset; (b) a ship or an aircraft subject to registration in a public register; or (c) **securities the existence of which requires registration in a register laid down by law; the validity of that act shall be governed by the law of the State within the territory of which the immoveable asset is situated or under the authority of which the register is kept**”.

<sup>217</sup> Article 31 of the WUD reads as follows: “Where, by an act concluded after the adoption of a reorganisation measure or the opening of winding-up proceedings, a credit institution disposes, for consideration, of: [...] - instruments or rights in such **instruments the existence or transfer of which presupposes their being recorded in a register, an account or a centralised deposit system held or located in a Member State, the validity of that act shall be governed by the law of the Member State [...] under the authority of which that register, account or deposit system is kept**”.

<sup>218</sup> Article 291 Solvency II reads as follows: “The following law shall be applicable where, by an act concluded after the adoption of a reorganisation measure or the opening of winding-up proceedings, an insurance undertaking disposes, for consideration, of any of the following: [...] (c) in regard to **transferable or other securities, the existence or transfer of which presupposes entry in a register or account laid down by law or which are placed in a central deposit system governed by the law of a Member State, the law of the Member State under the authority of which the register, account or system is kept**”.

Third, the evaluated conflict of laws rules are also indirectly related to two other pieces of EU financial legislation, namely the Central Securities Depositories Regulation ('CSDR')<sup>219</sup> and the Markets in Financial Instruments Directive ('MiFID II')<sup>220</sup>, although neither of these instruments contains conflict of laws rules:

- Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD are related to the Central Securities Depositories Regulation in that Article 38(5) of the CSDR introduces for a participants of a CSD the obligation to offer its clients the choice between 'omnibus client segregation' and 'individual client segregation'. If clients choose 'individual client segregation', then the securities are credited in the name of the investor in the individually segregated client accounts at CSD level and possibly throughout the chain of several other intermediaries, including at the investor account at the lowest tier level. Such a situation potentially creates new problems on establishing which is the 'relevant' account under the EU conflict of laws rules, as revealed by the discussions with the members of the Expert Group: "*where a French investor accessed the Spanish CSD through a French custodian, under Spanish law any security right needed to be registered in the Spanish CSD which was the relevant account for conflict of laws purposes, if an individual client account was used. Under French conflict of laws the relevant account was at custodian level and any security right was to be registered there. In many countries there seems to be a dual system of connecting factors depending on the account structure: one level of account is deemed relevant for securities held in individual accounts at CSD level, and potentially multiple accounts are deemed relevant if omnibus accounts are being employed*"<sup>221</sup>. Against this background, the EU conflict of laws rules could benefit from an explicit clarification which is the relevant account, when 'individual client segregation' is applied throughout a cross-border chain.
- Article 9(2) of the SFD and Article 24 of the WUD are related to the Markets in Financial Instruments Directive II in that they use the MiFID II definition of 'financial instruments' to define the material scope of the two conflict of laws rules. However, Article 9 of the FCD is based on a self-standing definition of 'financial instruments' which is different than the MiFID II one. In the conflict of laws public consultation of 2017 the suggestion has been made to align the definition of 'financial instruments' between the directives by uniformly using the reference to the MiFID II definition, but qualified to apply only to interests capable of being recorded in a register or account<sup>222</sup>.

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<sup>219</sup> Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories

<sup>220</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments

<sup>221</sup> See minutes of the second meeting of the Expert Group on Conflict of Laws on Securities and Claims, Brussels 15-16.5.2017, Ares(2017)3159733, [http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail\\_groupDetailDoc&id=33452&no=2](http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail_groupDetailDoc&id=33452&no=2), p. 3.

<sup>222</sup> Response of City of London Law Society to Question 4.

To sum up, the coherence of the conflict of laws rules in the SFD, the FCD and the WUD both internally and with other pieces of EU legislation could be improved.

#### **Question 5: What is the EU added value of the intervention?**

*To what extent have Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD helped to increase legal certainty and to what extent does the legal risk related to cross-border transactions continue to require action at EU level?*

Regarding the EU added value, the evaluated EU conflict of laws rules largely reduced the legal risk related to cross-border transactions which was huge more than a decade ago.

In 1998, Article 9(2) of the SFD introduced for the first time a harmonised approach throughout the EU and endorsed PRIMA to collateral transactions within the limited scope of designated systems and with central banks. This conflict of laws rule has served as a foundation for a wider codification of this than innovative approach and clarified the law applicable to securities held through a modern multi-tiered system.

In 2001, Article 24 of the WUD broadly restated the connecting factor of Article 9(2) of the SFD for the purpose of enforcement of property rights in financial instruments in insolvency proceedings of credit institutions.

In 2002, Article 9 of the FCD complemented Article 9(2) of the SFD and extended its application to the wholesale market. At this occasion the wording of the connecting factor was improved. In addition, Article 9(2) of the FCD defined the circumstances in which the conflict of laws rule selected by Article 9(1) of the FCD was to apply, thereby removing some of the ambiguities of the limited scope of application of its precursor. By selecting the domestic law, Article 9(1) of the FCD made also clear that *renvoi* is excluded, which is what Article 9(2) of the SFD probably intended but did not make express.

The combined scopes of Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD probably cover the greatest part of the wholesale market with a rule based on PRIMA. Nevertheless, this EU conflict of laws framework is not enough to fully guarantee legal certainty as to the law applicable to cross-border acquisitions of property rights in securities. As a basic concern, the wording and therefore the exact connecting factor of the existing rules is not consolidated and the reference to the location of the account is not clarified. Furthermore, there is a lack of uniform solutions in the areas that fall outside the scope of the directives.

Therefore, further EU action is desirable both (i) to cure the inconsistencies arising under the existing *acquis* and (ii) to provide a uniform conflict of laws regime across the Union where no EU legislation exists today, including retail accounts.

## **Section 8 Conclusions**

### **Effectiveness and efficiency:**

There is residual theoretical legal uncertainty arising from different national transpositions but also in inconsistency and limited scope of the EU conflict of law rules themselves. This

theoretically translates into a potential issue where several laws can become applicable in situations where there are several parties to a transaction, one falling within the scope of the directives but the other(s) outside, leaving it to the national conflict of laws rules to determine the applicable law which may potentially differ from the one designated according to the directives<sup>223</sup>. Thus, the legal uncertainty arises from (i) inconsistencies among the directives, (ii) inconsistencies among national transpositions of the directives and (iii) possible clashes between the harmonised and unharmonised field.

The evaluation has revealed that the EU intervention has not been fully effective and efficient due to the following factors:

(i) conflict of laws rules of the directives have been transposed and are being applied differently among Member States;

(ii) problems for market participants arise that stem from transpositions or from differences between transpositions;

(iii) the limited scope of the EU conflict of laws rules and uncertainties relating to their application do not provide a sound legal framework across EU and thus do not solve the issue of legal uncertainty as to the law applicable to cross-border transactions in securities.

#### **Coherence:**

Although Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD are all based on PRIMA and are broadly aligned with each other, the internal coherence between the rules could be further improved. In addition, some uncertainties about the interplay between the EU conflict of laws rules and other pieces of EU legislation have been identified. Regarding EU added value, Article 9(2) of the SFD, Article 9 of the FCD and Article 24 of the WUD were successful in modernising Member States' conflict of laws more than a decade ago. The increased integration of today's securities markets would warrant legal certainty as to applicable law, and this can be only achieved by a more consistent implementation of the rules.

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<sup>223</sup> Expert Group, Meeting Minutes of the 15-16 May 2017 meeting; available at: <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=33452&no=2>