Applicable legislation in the event of conflicts of law in cross-border transactions of claims and securities. June 2018.

The European Commission (EC) has identified reducing legal uncertainty in cross-border transactions of securities and credits as one of the key elements for achieving more integrated capital markets, within the framework of the interim review of its *Action Plan on the Capital Markets Union*, conducted in June 2017.

In fact, in the aforementioned document the EC recognises from the outset that the difficulties which may arise when determining which entity has legal title over claims or securities that have been the subject of cross-border transactions (resulting from the possible confusion as to which law is applicable, due to the fact that several countries are involved) may limit the number of cross-border investments and, ultimately, the development of the domestic market.

For this reason, the Commission published two initiatives on 12 March 2018 for the purpose of providing greater legal certainty in this respect.

The first initiative consists of a proposal for a Regulation to establish conflict of law rules; in other words, provisions to determine which national legislation applies in terms of the third-party effects of assignments of claims. As a general rule, this proposal establishes that the third-party effects of assignments of claims should be governed by the law of the country which is the assignor's habitual residence at the time the assignment takes place.

The second initiative is a Communication addressed to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions on the legislation applicable to transactions with securities in the event of a conflict of law related to ownership. Its common approach is to consider the applicable law to be that of the country where the relevant register or account is located.

The matter of the law applicable to the third-party effects on assignments of claims could have been addressed in the *Rome I Regulation* (Regulation (EC) no. 593/2008 of 17 June 2008 on the law applicable to contractual obligations), which incorporated the content of the *Convention on the law applicable to contractual obligations* (*1980 Rome Convention*), but in the end it was not included due to the complexity of the matter and a lack of time. However, Article 27, Paragraph 2 of the aforementioned regulation tasked the EC with the preparation of a report and, if appropriate, a regulatory proposal on the effectiveness of the assignment of claims against third parties and the priority of the assignee over the right of another person. This report was published in September 2016 by the British Institute of International and Comparative Law at the request of the Commission. Later, during 2017, the Commission published an impact analysis, launched a public consultation, and set up an expert group with the aim of finding possible solutions to the difficulties detected in respect of this matter.

Finally, in March 2018, as stated earlier, the EC presented a proposal for a regulation on the law applicable to the third-party effects of assignments of claims.

As a general rule, this proposal establishes that the third-party effects of assignments of claims should be governed by the law of the country which is the assignor's habitual residence at the time the assignment takes place. The EC chose this option because, in the public consultation it conducted, the interested parties considered that this law was the easiest to establish and the one which provided the greatest legal certainty. In the case of syndicated loans, this rule is also applied, but the law regarding the habitual residence of the assignor only affects the assignment made by each creditor in respect of their own part of the loan.

As a first exception to this general rule the proposal points out that the third-party effects of assignments consisting of the crediting of cash in an account open in a credit institution or of assets derived from financial

instruments must be governed by the law of the assigned claim. That is to say, in both cases the applicable law is the one governing the claim in the original contract between the creditor and the debtor, which is subsequently assigned by the creditor (assignor) to a new creditor (assignee).

Thus, for example, if the financial instrument is a derivative, a possible asset of this derivative would be the claim resulting from the amount owed after the calculation of its settlement. In this case, in the event of there being a conflict of law situation, the law of the assigned claim would be applied, which would coincide with the law governing the contract of the financial instrument from which the claim arises. It should also be noted that the contractual obligations arising from the transfer of financial instruments, together with the clearing and settlement of such instruments, will continue to be governed by the *Rome I Regulation*, whose general rule is that the parties can either choose the law applicable to contracts or it is determined by non-discretionary rules applicable to financial markets.

A second exception would be in respect of the third-party effects of the assignment of claims subject to securitisation, for which the proposal allows the choice of the applicable law to be decided by the assignor and assignee. The EC chose this option in order to make it possible for large operators participating in a securitisation transaction to choose the law of the assigned claim, so that the legal title of assigned claims is determined by the law applicable to the initial contract between the creditor/assignor and the debtor. Conversely, when the operators involved are smaller, thanks to the proposed formula, and if it is in their interest, they are able to choose to apply the law of habitual residence of the assignor since, in general, the claims included in their securitisation packages are governed by the laws of different countries.

Furthermore, when the same claim is the subject of a number of assignments and the third-party effects of one of them is governed by the law of the country in which the assignor has their habitual residence, while the others are governed by the law of the assigned claim (for example, this can happen if the claim in the first transaction is assigned for factoring operations and in the second for securitisation), the priority among the assignees affected will be governed by the law applicable to the third-party effects of the assignment of claims which first became effective against third parties under its applicable law.
In terms of the scope of application of the applicable law, this should be determined by two major issues related to the legal title of the assigned claim: the effectiveness of the assignment of the claim against third parties and priority in the event of a conflict between competing claimants (for example, between an assignee and a beneficiary).

COMMUNICATION FROM THE COMMISSION ON THE APPLICABLE LAW TO THE PROPRIETARY EFFECTS OF TRANSACTIONS IN SECURITIES

There are, however, standardised rules on conflicts of law in the European Union (EU) which determine the law applicable to the proprietary effects of transactions in book-entry securities or financial instruments or transactions whose existence or transfer presupposes a register. These are the *Directive on financial collateral arrangements* (hereinafter the Financial Collateral Directive), the *Directive on settlement finality* (hereinafter the Settlement Directive), and the *Directive on the reorganisation and winding up of credit institutions* (hereinafter the Winding-up Directive).

However, the European Central Bank has estimated that the volume of cross-border investments in securities in 2016, taking into account the residence of the investor, amounted to only a fifth of the total volume of securities deposited in central securities depositories with accounts in the EU. After analysing this figure the EC considered that greater clarity regarding the rules relating to conflicts of law could help increase this amount.

Consequently, for the reasons stated above, in this matter the EC deemed it sufficient to publish a *Communication addressed 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*. The purpose pursued by the EC with this initiative is to provide greater legal certainty when determining which country's rules should be applied to determine the proprietary effects of cross-border transactions of securities (in particular, with regard to the assignment of proprietary rights).

This Communication starts by identifying the rules on securities which contain specific provisions on conflicts of laws applicable to cross-border transactions of securities, before going on to address certain ambiguities in those provisions. The Communication recognises that all of them are based on a common approach, since they consider the applicable law to be that of the location of the relevant register or accounts. However, the different wordings of these provisions have given rise to different interpretations and applications in the Member States, particularly with regard to the definition and determination of the place where the account is "*located*" or "*maintained*".

Thus, while Article 9, Paragraph 2, of the Settlement Finality Directive and Article 24 of the Winding-up Directive, consider the applicable law to be that of the Member State in which the register or the account "is located", Article 9, Paragraph 1 of the Financial Collateral Directive refers to the law of the country in which the account in question "*is maintained*".

With regard to this point the Commission concludes that the terms "is located" and "is maintained" used in these directives may be considered to be equivalent. It bases this conclusion on the following considerations: a) Recital 7 of the Financial Collateral Directive recognises that the objective of the provision on conflicts of law is to extend the principle already established in the Settlement Finality Directive, therefore in the opinion of the Commission both sets of rules are aligned; b) the formula contained in the Financial Collateral Directive is more appropriate since it reflects the trend in EU securities markets; and c) some language versions of the directives use the same terminology in these provisions, as is the case of the French, Italian and Romanian versions.

Another point which this Communication attempts to clarify concerns the various ways in which Member States have determined in their respective legal systems where a securities account "*is located*" or "*is maintained*". The EC recognises the lack of clarity in this respect in the three aforementioned directives. It only points out that from Recital 8 of the Financial Collateral Directive we may deduce that the common basis for resolving conflicts of law throughout the EU is the principle of *lex rei sitae*, according to which the applicable legislation for deciding whether a financial collateral arrangement has been properly perfected and therefore good against third parties is that of the country in which the financial collateral is located, a principle which is currently also recognised in all Member States.

Consequently, the Communication concludes by recognising the validity of the various national interpretations, without prejudice to potential future decisions of the Court of Justice of the European Union.

The Communication also observes how some Member States have enshrined this principle. For example, some interpret and apply the provisions on conflicts of law of the Financial Collateral Directive by taking into account the location at which the custody services are provided. Others base their interpretation on the account opening contract – to find out where the account is maintained – or permit the law of any Member State to be chosen, provided that it is valid under the Hague Convention on securities.

Finally, the Communication recommends that national authorities and administrations should take into account the clarifications it provides, and should continue to observe if any legal discrepancies occur at a national level that might require greater convergence. For its part the Commission undertakes to continue to monitor developments in this area and does not rule out consulting interested parties or considering the possibility of a legislative initiative in the future.

Links of interests:

Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims

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