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**The Hague and Geneva Securities
Conventions: a Modern and Global
Legal Regime for Intermediated
Securities**

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The Hague and Geneva Securities Conventions: a Modern and Global Legal Regime for Intermediated Securities

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I. – INTRODUCTION

The need for uniform rules that comport with the reality of how investment securities are held, transferred and collateralised today (*i.e.*, by electronic book-entries to securities accounts) has become critical.¹ Legal uncertainty as to the perfection, priority and other effects of domestic and cross-border transfers of such securities imposes significant costs on even routine transactions and operates as an important constraint on desirable reductions in credit and liquidity exposures. Increased exposure to unsecured credit risk amplifies systemic risk and the potential proliferation of the number of

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All websites referred to in this article were last visited on 9 August 2012.

¹ The total outstanding amount of domestic debt securities issued by governments, financial institutions and corporate issuers, for example, was 69,912.7 billion USD in December 2011, while the total outstanding amount of international debt securities by such issuers was 29,665.5 billion USD in March 2012. See BANK FOR INTERNATIONAL SETTLEMENTS, *BIS Quarterly Review: International Banking and Financial Market Developments* (June 2012), (p.) A 114-117 and A 124-125. See also WORLD FEDERATION OF EXCHANGES, *2011 WFE Market Highlights* (19 January 2012), available at <<http://www.world-exchanges.org/files/file/stats%20and%20charts/2011%20WFE%20Market%20Highlights.pdf>>.

insolvencies. To address these concerns, States from around the world have negotiated and adopted two international Conventions relating to intermediated securities.

The first of these Conventions was developed under the auspices of the Hague Conference on Private International Law (hereinafter: Hague Conference) and is entitled the *Hague Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* (hereinafter: Hague Securities Convention, or HSC). The Hague Securities Convention is a pure *conflict of laws* Convention. As such, it applies in cross-border situations and establishes “road signs” that point to the State whose law governs the issue at stake (in other words, the HSC does not set out substantive rules relating to intermediated securities). The second Convention was developed under the auspices of the International Institute for the Unification of Private Law (hereinafter: UNIDROIT). It is entitled the *UNIDROIT Convention on Substantive Rules for Intermediated Securities* (hereinafter: Geneva Securities Convention, or GSC) and was adopted in Geneva on 9 October 2009. The Geneva Securities Convention harmonises a set of important *substantive law* issues (in other words, it does not set out conflict of laws rules relating to intermediated securities).

Thus, while both Conventions deal with the same general subject matter – intermediated securities – they serve a different purpose and answer two distinct questions: while the Hague Securities Convention answers the basic question as to *which law applies* to a series of practically important questions relating to the holding, transfer and collateralisation of intermediated securities in a cross-border context, the Geneva Securities Convention sets out the actual *content* of the law governing the issues at stake. The two Conventions thus neither duplicate nor compete with each other. Quite to the contrary, the two Conventions are complementary to each other and both should be carefully assessed by relevant State officials and market participants. Both instruments were negotiated by experts from around the world representing all major legal systems as well as financial markets in both developed and developing States. These experts included not only government officials and academics, but also leading practitioners and representatives of the securities industry, central banks and financial market regulators. Importantly, both Conventions were adopted by full consensus. Both instruments therefore set out the most authoritative, internationally agreed solutions to often highly technical and complex issues.

This article gives an overview of the key features of the HSC and the GSC. It is intended for those who wish to become acquainted with these two related

Conventions. For an in-depth, article-by-article analysis, the reader is referred, in particular, to the *Explanatory Report on the Hague Securities Convention*² and the *Official Commentary on the UNIDROIT Convention on Substantive Rules for Intermediated Securities*.³ The websites of the Hague Conference and UNIDROIT not only provide the texts of the Conventions and information on their latest status, but also all preliminary documents prepared and discussed during the negotiations.⁴

II. – HAGUE SECURITIES CONVENTION

The Hague Securities Convention sets out a conflict of laws regime for intermediated securities.⁵ This regime:

- provides legal certainty as to the law applicable to clearing, settlement and secured credit transactions that have any cross-border element;
- markedly improves transactional efficiencies in global securities markets;
- reduces systemic risk in cross-border transactions and intermediary holdings; and
- facilitates cross-border capital flows and contributes to creating an environment that is more conducive to foreign investments.

As indicated, the HSC deals with the question of the applicable law, but does not set out substantive law rules. Article 4 HSC is the key provision of the Convention. It sets forth the primary conflict of laws rule to determine the law

² The Explanatory Report of the HSC was prepared by Professor Roy Goode (United Kingdom), Professor Hideki Kanda (Japan) and Professor Karl Kreuzer (Germany), with the assistance of Dr Christophe Bernasconi (Permanent Bureau of the Hague Conference). It was published by Martinus Nijhoff Publishers (2005) and may be ordered through the website of the Hague Conference (<www.hcch.net>).

³ The Official Commentary on the GSC was prepared by Professor Hideki Kanda (Japan), Professor Charles Mooney (USA), Professor Luc Thévenoz (Switzerland) and Stéphane Béraud (France), with the assistance of Dr Thomas Keijser (UNIDROIT Secretariat). It was published by Oxford University Press (2012) and may be ordered through that publisher's website (<www.oup.com>).

⁴ <http://www.hcch.net/index_en.php?act=conventions.text&cid=72> (HSC) and <<http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm>> (GSC). These main pages contain links to further information.

⁵ For an extensive bibliography on the HSC, see <http://www.hcch.net/index_en.php?act=conventions.text&cid=72>.

applicable to all the issues falling within the scope of the HSC. Most importantly, the rule is not based on an attempt to “locate” a securities account, the office at which a securities account is maintained, an intermediary, the issuer, or the underlying securities.⁶ Rather, the HSC’s primary rule is based on the *relationship between an account holder and its intermediary*: it gives effect to the express agreement by the parties to an account agreement on the law governing all the issues falling within the scope of the HSC. This choice may be expressed in either of two ways: if the parties expressly agree on a law governing their account agreement (general governing law clause), that law also governs all the issues falling within the scope of the HSC (on the HSC’s scope of application, see the following paragraphs in this Section); if, however, the account holder and its relevant intermediary expressly agree that the law of a particular State will govern all the issues falling within the scope of the HSC, that law governs all these issues (whether or not there is also a separate choice of law to govern the account agreement generally). In either case, the law chosen by the parties to the account agreement applies only if the relevant intermediary has, at the time of the agreement on governing law, an office (“Qualifying Office”) in the State whose law is selected which, alone or with another office or third party (which does not have to be in the selected State), serves certain functions relating to the maintenance of securities accounts (though not necessarily the particular account in question), or is identified, by any specific means, as maintaining securities accounts in that State (though not necessarily the particular account in question). If the applicable law is not determined under Article 4 HSC, Article 5 HSC sets out a series of fall-back provisions that ultimately result in the application of the law of the jurisdiction in which the intermediary is incorporated or otherwise organised, or where it has its place of business.

The law determined under the HSC applies to all the issues enumerated in the exhaustive but very *broad and intentionally very generally worded list in Article 2(1) HSC*. This list includes all issues that are of practical importance

⁶ After comprehensive and inclusive discussions, fact-finding and widespread consultation, it became obvious to all experts involved that, given the realities of the operations of intermediaries in today’s globalised marketplace and current technology, there exists no criterion – acceptable on a *global* basis and applicable to *all* intermediaries and *all* securities held through intermediaries – on the basis of which the location of a securities account or the office at which an intermediary maintains the account can objectively and realistically be determined with the required degree of certainty.

in relation to the holding, transfer and collateralisation of intermediated securities. Most significant among these issues are the *legal nature and effects against the intermediary and third parties of rights resulting from a credit of securities* to a securities account (Article 2(1)(a) HSC), and the *legal nature and effects against the intermediary and third parties of a disposition*⁷ of intermediated securities (Article 2(1)(b) HSC). The approaches to intermediated securities vary among legal systems. In some systems, the account holder's rights resulting from a credit of securities to a securities account are characterised as a form of property right. In other systems, the account holder's rights are characterised as a form of purely personal (contractual) right against the intermediary to the delivery or transfer of a given type and number of securities. In yet other systems, the account holder's rights are characterised or denominated as the interest of a beneficiary under a trust, a fiduciary interest, a *Gutschrift in Wertpapierrechnung*, co-property rights in a fungible, notional or book-entry pool of securities, security entitlements or some other bundle of property, contractual or other rights.⁸ These differences, however, do not matter under the HSC, which caters to the needs of *all* these approaches and applies to intermediated securities regardless of how the relevant substantive law classifies the nature of the right resulting from the credit of the securities to the securities account and independently of whether this right is against the investor's intermediary, any other intermediary or the issuer. For the sake of clarity and to avoid any doubt, Article 2(2) HSC explicitly confirms the Convention's applicability even in situations where, under the Convention law, the rights resulting from the credit of securities to a securities account are determined to be contractual in nature.⁹

⁷ As defined in Art. 1(1)(h) HSC, the term "disposition" covers any transfer of title, whether outright or by way of security, and any other form of security interest. "Disposition" includes sale and repurchase (repo), purchase and resale (reverse repo), transfers under sell/buy-back or buy/sell-back arrangements and stock loans.

⁸ For a more complete discussion of the various substantive law models, see the Explanatory Report on the HSC, paras. Int-22 and Int-23, 2-11 *et seq.* (with further references). See also paras. Int-28 and 1-15 of the Official Commentary on the GSC and the text in Section III below.

⁹ Unfortunately, the English and French texts of Art. 2(2) HSC do not match. While the English text correctly refers to both a "disposition of" and "an interest in" securities (and thus covers both dynamic and static situations), the French text only refers to a disposition (of either securities or an interest in securities). The history and purpose of Art. 2(2) HSC clearly reveal that the English version is correct and that the French text must be read accordingly. This result is expressly confirmed by the Explanatory Report, para. 2-31.

Other important issues listed in Article 2(1) HSC, and thus governed by the Convention law determined under Article 4 (or Article 5) HSC, include *perfection* requirements of a disposition and whether an interest extinguishes or has *priority* over another person's interest. Furthermore, the Convention law also governs whether an intermediary has any duties to *a person other than the account holder who asserts, in competition with the account holder or another person, an interest in securities* held with that intermediary (Article 2(1)(e) HSC). This includes, for example, whether the intermediary is protected if it honours an instruction from one claimant even if it is later found that another claimant has priority. It also includes the important question whether so-called *upper-tier attachments* are permissible (*i.e.*, an effort to reach an account holder's interest in securities by levying an attachment against an intermediary at a level above that of the account holder's intermediary).

The HSC also deals with a number of *other important considerations*. Article 7 HSC sets out the protection of rights in case of an amendment to an account agreement if the consequence of the amendment is that the Convention law changes from the law of one State as determined under either Article 4(1) or Article 5 HSC, to the law of a different State as determined under Article 4(1). Article 8 HSC fixes the boundary between the Convention law (*lex causae*) and the applicable insolvency law (*lex concursus*) in the context of an insolvency proceeding. It provides that pre-insolvency rights, which are effective and perfected under the Convention law, are to be respected as such in an insolvency proceeding (Article 8(1) HSC). However, these rights are not thereby exempted from general insolvency rules relating, for example, to the ranking of claims, the avoidance of unfair preferences and transactions in fraud of creditors, or the enforcement of rights (Article 8(2) HSC). Article 11 HSC carefully restricts the grounds for judicial refusal to apply the Convention law based on grounds of public policy. Article 12 HSC sets forth several important interpretive and substantive provisions relating to the application of the Convention with regard to multi-unit States (*i.e.*, States within which two or more territorial units of that State, or both the State and one or more of its territorial units, have their own rules of law in respect of any of the Article 2(1) issues). Finally, Articles 15 and 16 HSC contain some transition provisions.

It is important to note that the HSC has no impact on *regulatory schemes* relating to the issue or trading of securities, regulatory requirements placed on intermediaries or enforcement actions taken by regulators. Thus, supervisory authorities are, in the exercise of their authority, free to prohibit intermediaries

from choosing any governing law (“no choice at all”), or choosing a particular governing law (“cannot be X, Y or Z”), or choosing a governing law other than the law specified by the authority (“must be X”).

The HSC was signed by the United States of America and Switzerland on 5 July 2006.¹⁰ The first States to ratify the HSC were Switzerland and Mauritius (both in 2009).

III. – GENEVA SECURITIES CONVENTION

The Geneva Securities Convention harmonises a number of important substantive law issues relating to intermediated securities.¹¹ Key advantages of the GSC are that it:

- provides an international legal benchmark for the holding, transfer and collateralisation of intermediated securities;
- gives guidance on how to structure a domestic legal framework;
- facilitates the compatibility of legal systems;
- makes cross-border transactions easier and less expensive; and
- limits legal, operational and therewith systemic risk.

The GSC is divided into *seven chapters*. Chapter I (Articles 1-8) contains definitions and relates to the GSC’s sphere of application and principles of interpretation. Chapter II (Articles 9-10) deals with the rights of the account holder and the related obligations of the account holder’s intermediary. Chapter III (Articles 11-20) contains provisions relating to the transfer of and establishment of limited rights in respect of intermediated securities, while Chapter IV (Articles 21-30) sets out different rules that ensure the integrity of the intermediated holding system. Chapter V (Articles 31-38) contains optional rules for collateral transactions. Chapter VI (Article 39) consists of a transitional

¹⁰ This joint signing gave the HSC its date (5 July 2006), although the final text of the HSC was adopted at the end of the 19th Diplomatic Session of the Hague Conference in December 2002.

¹¹ For an overview of the GSC which was published before its Official Commentary, see C. MOONEY, “The (UNIDROIT) Geneva Securities Convention on Intermediated Securities”, *Butterworths Journal of International Banking and Financial Law*, 10 (2009), 596-598. For an in-depth analysis of the (draft) GSC, see L. Gullifer / J. Payne (Eds.), *Intermediated Securities: Legal Problems and Practical Issues*, Oxford: Hart Publishing (2010). This book also pays attention to conflict of laws issues.

provision. Finally, Chapter VII (Arts. 40-48) contains final provisions that are commonly found in modern commercial law treaties.

The GSC should be read in close connection with a *Declarations Memorandum* and a document containing information for Contracting States in respect of the *references in the GSC to sources of law outside that Convention*.¹² The first of these documents contains information for Contracting States on the declarations that can be made under the GSC. The second document contains a comprehensive overview of issues that are not regulated in the GSC. While the GSC harmonises a number of key substantive law issues, it also refers a considerable number of issues to sources of law outside the Convention, including to the so-called “non-Convention law”. The second document could well be the basis for further harmonisation efforts in the form of a legislative guide with principles and rules capable of enhancing trading in securities in emerging markets.¹³

The drafters of the GSC took a *functional approach*. This means that the legal terminology used in the GSC is not derived from specific jurisdictions but is neutral, so as to be capable of being applied in different types of legal systems, including civil law, common law and mixed legal systems.

Like the HSC (see Section II above), the GSC was drafted with *different types of holding systems* in mind. The GSC can be applied to systems in which an account holder’s claim is contractual or is based on, for example, a (co-)ownership or a trust concept, on a *sui generis* notion such as an account holder’s “entitlement” to securities, or any other notion. Likewise, the GSC can operate in the context of both “transparent” and “non-transparent” systems. In a transparent system, one or more entities in the holding chain share the carrying out of functions relating to the maintenance of a securities account with the account holder’s relevant intermediary. In a non-transparent

¹² See UNIDROIT 2012 – DC11/DEP/DOC. 1 rev. (April 2012) and UNIDROIT 2011 – S78B/CEM/2/DOC. 2 (November 2011). Originally, these two documents were set out in a single document, written by Thomas Keijser in cooperation with José Angelo Estrella Faria (Secretary-General of UNIDROIT); see UNIDROIT 2010 – S78B/CEM/1/Doc. 3 (August 2010). The Declarations Memorandum is available at <<http://www.unidroit.org/english/conventions/2009intermediatedsecurities/depositaryfunction/main.htm>>, the other two documents at <<http://www.unidroit.org/english/workprogramme/main.htm>>.

¹³ For more information on such possible future work, see the “Work in Progress” section on the UNIDROIT website. The United Nations Commission on International Trade Law is contemplating future work on non-intermediated securities in the context of its Working Group VI on Security Interests (see <www.uncitral.org>).

system, the relevant intermediary carries out all such functions itself. Article 7 GSC ensures that both types of system can profit from the legal solutions offered by the Convention.

The three key participants in the intermediated holding system are the account holder, the intermediary (or rather, the chain of intermediaries) and the issuer. The GSC pays most attention to the rights and obligations of the account holder and the intermediary and leaves the position of the issuer largely untouched. Article 9 GSC sets out the *rights of the account holder*, including income and voting rights, and the account holder's right to transfer its securities or encumber them with a limited right. Article 10 GSC lists the principal *obligations of an intermediary* towards its account holders and in relation to its role in maintaining the integrity of the intermediated holding system.

Articles 11, 12 and 13 GSC cover different methods for the *acquisition and disposition* of intermediated securities. Article 11 GSC recognises the debit and credit method, while Article 12 GSC allows Contracting States also to recognise automatic perfection of interests granted by an account holder to its relevant intermediary, designating entries and control agreements. It is possible by each of these four methods to effect a full transfer of title of, and establish a limited interest in intermediated securities. Article 13 GSC allows Contracting States also to envisage other, non-Convention methods for the acquisition and disposition of intermediated securities.

Article 14 GSC determines that rights and interests that have become effective against third parties under Articles 11 or 12 GSC are generally effective in *insolvency proceedings*. This rule applies against the insolvency administrator and creditors. The rule does not, however, affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding, such as any rule relating to (a) the ranking of categories of claims; (b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; or (c) the enforcement of rights to property that is under the control or supervision of the insolvency administrator. It is worth noting that Article 21 GSC provides a special rule of protection of rights and interests that have become effective against third parties in the "vertical" situation of the insolvency of an account holder's relevant intermediary.

Article 18 GSC offers protection to an *innocent acquirer* of intermediated securities or an interest therein, while Articles 19 and 20 GSC set out *priority rules* that apply in case of competing interests in the same intermediated securities.

A number of provisions of the GSC protect the integrity of the intermediated holding system. One of these is Article 22 GSC which *prohibits upper-tier attachment*. Essentially, this means that an account holder's creditor can only attach that account holder's intermediated securities at the level of the account holder or its relevant intermediary, but not at higher levels in the holding chain. Other core rules related to the integrity of the holding system are the *intermediary's obligation to hold or have available sufficient securities* to cover credits to its account holders' securities accounts (Article 24 GSC), and its obligation to *allocate securities to account holders' rights* (Article 25 GSC).

Some additional insolvency rules are set out in Article 26 GSC, which deals with *loss sharing* in case of the insolvency of the intermediary, and Article 27 GSC, which sets out rules regarding the *finality of (instructions to make) book entries* in case of the insolvency of a system operator or a participant in that system.

Article 28 GSC contains the minimum rule that an intermediary may not exclude *liability* for its gross negligence or wilful misconduct. The non-Convention law (and specified other sources of law outside the GSC) may impose liability on an intermediary also in other cases.

The collateral chapter of the GSC gives rules for important financial products such as repurchase, securities lending and derivatives agreements. In cases where the parties provide collateral by way of the title transfer technique, Article 32 GSC *prevents "re-characterisation"* of such a title transfer as a securities interest by determining that a title transfer agreement can take effect in accordance with its terms. Where the parties apply the security interest technique, Article 34 GSC allows the parties to agree upon a *"right of use"*, which means that a collateral taker has an unlimited right of disposal, comparable to that of the owner, in relation to the securities provided as collateral. By exercising such a right of use, the collateral taker incurs a contractual obligation to deliver replacement collateral to the collateral provider. The collateral chapter also contains detailed rules on *enforcement* (Articles 33 and 35 GSC), and on *top-up collateral* and *substitution of collateral* (Article 36 GSC). Note that this chapter of the GSC is *optional*: a Contracting State can opt out of the entire chapter or may limit its scope of application (see Article 38 GSC).

As a principle, the GSC does not limit or otherwise affect the powers of Contracting States to *regulate, supervise or oversee* the holding and

disposition of intermediated securities. However, such regulation, supervision or oversight should not contravene the provisions of the GSC.¹⁴

The GSC was signed by Bangladesh during the closing ceremony of the diplomatic Conference that adopted the GSC in 2009. The recent publication of the Official Commentary on the GSC in May 2012 is expected to facilitate further *signatures and ratification, acceptance, approval or accession* by States.

IV. – CONCLUDING REMARKS

The Hague and Geneva Securities Conventions provide internationally agreed rules for intermediated securities, which securities play a pivotal role in the financial markets. The HSC sets out conflict of laws rules and the GSC provides substantive law rules in relation to a number of key issues relating to the holding, transfer and collateralisation of such securities. While the two Conventions serve different purposes, they are complementary and perfectly compatible: a State may thus decide to become a Party to either or both Conventions, and if a State decides to join both Conventions, it may do so simultaneously or consecutively.

The HSC and GSC were agreed between States representing a multitude of different legal systems and traditions. The financial industry, central banks and regulators played a crucial role in the negotiations that led to the adopted texts. With respect to the HSC, the G30 issued the following, important statement:

“Financial supervisors and legislators should ensure that [the HSC] is signed and ratified by their respective nations as soon as is reasonably possible. [The HSC] will ensure that there will be a clear and certain answer to the question in an international setting as to which law governs in determining whether a collateral taker has received a perfected interest in pledged securities.”¹⁵

Importantly, there is also a close relationship between the *ex ante* legal certainty that the HSC and GSC are designed to achieve and the risk

¹⁴ See the tenth recital of the Preamble of the GSC. For the approach of the HSC in relation to regulation, supervision and oversight, see the text under Section II above.

¹⁵ GROUP OF THIRTY (G30), *Global Clearing and Settlement: A Plan of Action*, Washington (2003), Recommendation 15, (p.) 47; see also *Idem*, *Final Monitoring Report*, Washington (2006), (pp.) x and 13 (both available at <www.group30.org>). At the time, the GSC was still being negotiated. The G30 also supported the work in the field of substantive law.

management standards set out in the revised capital adequacy framework commonly known as the Basel Capital Accords (including Basel III).¹⁶ Likewise, the topics covered by the HSC and the GSC tie in neatly with calls for sound and internationally convergent rules in recommendations relating to cross-border banking resolution of the Basel Committee's Cross-border Bank Resolution Group¹⁷ and the Financial Stability Board.¹⁸

The adoption of the benchmarks set out in the Hague and Geneva Securities Conventions will lead to sound domestic and internationally compatible rules for intermediated securities, which will enhance liquidity and the stability of the financial system, both in a domestic context and worldwide.



¹⁶ E.g., the quality of collateral – and thus ultimately the capital ratio – also depends on the legal certainty (provided by the HSC) as to the law governing that collateral, including any perfection requirements, as well as the robustness of the substantive law governing the collateral (as provided by the GSC). Legal certainty and robustness enhance the quality of collateral and its enforceability, and thus ultimately lower the capital ratio. For more information on the Basel Capital Accords, see <www.bis.org>.

¹⁷ See BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, *Report and Recommendations of the Cross-border Bank Resolution Group*, Basel (March 2010), e.g., on various risk mitigation mechanisms (collateralisation, netting, segregation, etc.), section 8, (pp.) 36-39.

¹⁸ See FINANCIAL STABILITY BOARD, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011), section 4, (pp.) 10-11 (e.g., on set-off, netting, collateralisation, segregation).