

# NewsLetter

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## New Convention on Securities held with Intermediaries

**The Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary signed in the Hague on 13 December 2002 (the "Convention") marks a dramatic step forward on the long and winding road to establish a sound and efficient international legal system benefiting all financial intermediaries dealing with securities in the world's major financial markets. The relatively short drafting period leading to the final version of the Convention is evidence of the securities industry's need for such regulation. The core element of the new Convention is the so-called PRIMA approach.**

### Background

Financial intermediaries dealing in securities or accepting securities as collateral on an international scale are confronted with a legal situation that is unsatisfactory in many ways.



by Dr. Jörg A. Witmer  
+41 1 265 75 40  
jwitmer@wwp.ch

First, many national legal systems have not kept up with the rapid adoption of indirect holding systems, where securities are held in a system of electronic book-entries maintained by banks and centralised settlement

institutions. This system permits fast and efficient transfers of rights in such securities in large volumes and on a global scale. The handling of physical securities certificates is not a practical necessity, but it is cumbersome and costly. Nevertheless, the existence of a physical certificate often is still required under national laws.

Second, national laws regulating the transfer of rights in securities differ significantly from each other and banks or other intermediaries acting internationally must adapt their procedures in each country to observe national requirements.

Third, the question which law should apply in an international securities transaction is in many cases far from clear. National conflict of laws rules are often as outdated as the laws regulating the rights in securities themselves

and there are only a few international regulations, in particular in the EU, addressing these issues.

### Conflict of Laws Regulation

The Convention addresses specifically this third issue and aims to determine which national law is applicable to a transaction covered by the Convention's scope. In other words, the Convention is a typical conflict of laws regulation and refers only to the respective applicable national law (excluding its conflict of laws rules).

### Convention's Scope

The Convention applies to all international cases, i.e. cases where different national laws might apply (Article 3). Its scope is framed further in Article 2 by defining "intermediary" as "a person that in the course of a business or other regular activity maintains securities accounts for others or both others and its own account." The definition covers banks operating securities accounts for their customers and central securities depositories ("CSD") which in turn operate securities accounts for banks (for their own or their customers' accounts) participating in the settlement system operated by the CSD.

The Convention determines the applicable national law in respect of practically all issues relating to the legal nature and consequences of a credit to a securities account held with an intermediary or the disposition of securities from such an account. Importantly, the law governing the requirements for perfection of a disposition of securities held with an intermediary and the question whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's right is also determined by the Convention.

### PRIMA rule

PRIMA stands for the "place of the relevant intermediary". The relevant intermediary is defined quite simply as the intermediary that maintains the securities account for the account holder. The relevant intermediary is thus typically the bank (in relation to its customers and account holders) or the CSD (in relation to the bank or other institutions participating in the settlement system operated by the

CSD). PRIMA is the core concept of the Convention and it makes no reference to physical certificates. The particularly troublesome *lex rei sitae* rule calling for application of the law where physical certificates representing securities are located is expressly disclaimed by the Convention.

### Limited Choice of Law

The primary rule for the determination of the law applicable to the issues addressed in the Convention is set out in the Convention's Article 4, which states that the national law governing the account agreement shall govern the issues. The account agreement, however, can specify another applicable law. In both cases, a "reality test" applies, meaning that the law governing the account agreement, either as chosen in the agreement or by operation of law, applies only if the relevant intermediary has an office in that state which (a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another state (i) effects or monitors entries to the securities account, (ii) administers payments or corporate actions relating to securities held with the intermediary, or (iii) is otherwise engaged in the a business or other regular activity of maintaining securities accounts, or (b) is identified by an account number, bank code or similar identification as maintaining securities accounts in that state.

The Convention employs a negative checklist to ensure that technical facilities (EDP), call or mailing centres, or locations where only files or archives are kept or that only serve representational or administrative functions are not an office for the purpose of establishing the necessary physical nexus to the applicable national legal system.

### Fall-back Rules

If the applicable law cannot be determined under Article 4, Article 5 provides for a set of staggered fall-back rules. The applicable law would first be determined by the place of the relevant intermediary's office that entered into the account agreement, provided such office is expressly and unambiguously specified in the written account agreement. In second priority is the law of the contracting state where the relevant intermediary is incorporated or otherwise organised. The third and ultimate criterion is the relevant intermediary's (principal) place of business.

### Implications to Banks and other Intermediaries

The Convention provides for elaborate transition provisions which, given their complexity, cannot be outlined here. They will, however, because of their complexity, require a market participant's utmost

attention when drafting account agreements, agreements on the transfer and holding of securities (in the widest sense) and general business terms and conditions to ensure that the choice of law as provided for in Article 4 is properly implemented in the relevant legal documents.

### Assessment – and a Look Ahead

In Switzerland, no ratification or effective date is known as of today. Given the urgency of the matter and the rather positive reception of the Convention in the Swiss securities market, the ratification process is expected to start sooner rather than later.

It may seem regrettable at first that the Hague conference did not aim at harmonizing the applicable national laws of the signatory states or creating a true supra-national law. Given the complexity of the issues involved and the diversity of the national laws, however, such task would have been tremendously ambitious. For Switzerland, the signing of the Convention may provide the impetus to address the urgent need for revision of the Swiss securities regulation and implement a modern legal regime which fully takes into account the proven practises of intermediaries and the securities markets. A working group under the lead of the Federal Department of Finance has taken up initial work to revise the draft statute on custody and administration of securities. It must be hoped that the drafting and legislating process will be swift.

### NewsLetter

The ww&p NewsLetter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this NewsLetter should seek specific advice on the matters which concern them.

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**Walder Wyss & Partners**  
**Attorneys at Law**

Münstergasse 2  
P.O. Box 2990  
CH-8022 Zurich  
Phone +41 1 265 75 11  
Fax +41 1 265 75 50  
reception@wwp.ch  
www.wwp.ch

London Representative Office  
9 Gray's Inn Square  
London WC1R 5JQ  
Phone +44 20 7405 2043  
Fax +44 20 7405 0605