INTERNATIONAL SYMPOSIUM ON THE HAGUE SECURITIES CONVENTION

"IMPACT OF THE HAGUE SECURITIES CONVENTION ON MARKET PRACTICE - A JAPANESE PRACTITIONER'S VIEW"

AKIHIRO WANI
PARTNER
MITSUI, YASUDA & WANI

a. Introduction

Until The Long-Term Credit Bank of Japan, Limited, ("LTCB", now known as Shinsei Bank, Limited) became insolvent in October 1998 it was rare for collateral to be taken in the context of Japanese inter-bank transactions. Generally, collateral was thought to be necessary for retail market transactions only. At the time the International Swaps and Derivatives Association ("ISDA") launched its Credit Support Annex (Bilateral Form - Loan and Pledge) (Security Interest Japanese Law) to secure the obligations of parties under derivative transaction entered into pursuant to the ISDA Master Agreement, many people said that it would not be of much use because Japanese banks would never fail due to the armed convoy system of the Ministry of Finance (presently, the Financial Services Agency). However, the failure of LTCB followed by that of several other financial institutions completely changed market practice and it is now quite usual for collateral to be taken to secure even domestic inter-bank transactions. In the case of cross-border inter-bank transactions one could now say it is the rule (rather than the exception to the rule) for collateral to be taken.

The most common types of Japanese collateral used to secure exposures under derivative transactions are Japanese Government Bonds ("JGBs") and Yen cash. In addition, market participants sometimes use Japanese shares, corporate bonds, convertible bonds (including corporate bonds issued in the Euromarket by Japanese corporations), municipal government bonds and investment trust beneficiary certificates.

b. Current Status[1]

Article 10 of the Conflict of Laws of Japan (*Hourei*, Law No. 10 of 1898) adopts the *lex situs* approach in relation to the granting of security interests over personal property (which includes certificated shares, bonds, and cash). However, it should be noted that credits such as bank deposits are not regarded as personal property for the purposes of this rule. Instead credits should be characterized as contractual rights and consequently fall outside the application of the above rule.

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[1] See generally, Kanda: Japan (Potok: Cross Border Collateral, Legal Risk and the Conflict of Laws at 366) and Financial Law Board "Interim Note on Legal Rules to Book-Entry Securities Settlements" (see www.flb.gr.jp)

Applying the above rule, in the case where security is expressed to be taken over certificated bonds and shares, the proper law governing questions as to the enforceability of such security is the law of the jurisdiction in which the relevant bonds and shares are actually located. In the good old days when such collateral assets were held by their holders directly, it was quite an easy task to determine the governing law.

In the case of dematerialized bonds, the governing law for the creation of the security interest over the bonds is the governing law of the relevant bonds (or there is no explicit governing law, the law of the place of issuance) while the governing law in respect of security interests created over dematerialized shares is thought to be the law of the incorporation of the issuer. There is no clear statutory basis for applying different rules for shares and bonds but the distinction is based on the generally accepted interpretation of law that legal relationships with respect to shares should be governed by the law of the issuing corporation's jurisdiction of organization. However, it should be noted that the law governing the perfection of security interests over dematerialized bonds "against third parties" will be the law governing the location of the issuer of the bonds (Article 12, Conflict of Laws).

The situation becomes complicated when we try to find out the actual location of the bonds, for example, where such securities are certificated. If we take as an example the case of a bondholder who holds a Euro bond through a Japanese custodian. The Japanese custodian holds such bond through book-entry with its custodian in London. The London custodian holds a book entry interest in respect of such bond through its account with Euroclear. Euroclear holds such bond through its entry with the account of the relevant common depositary. However, where does the common depositary hold the actual global bond or the definitive bonds? At its headquarters? Its custodian's office? It may be difficult to find this out. Therefore, if a Japanese investor wants to create a security interest over a Eurobond for the benefit of its creditor, it may be difficult in practice to find out the law of the jurisdiction where such Eurobond is located to satisfy the requirements of the *lex situs*. Due to the uncertainty over where the actual Eurobond is located, market participants have sometimes taken a security interest over the Japanese bondholder's claim against his Japanese custodian instead. This approach may be workable where the security interest holder is also the custodian but it does not have a strong legal basis under the current *lex situs* approach.

c. Impact of the Hague Securities Convention

The expected ratification of the Hague Securities Convention ("the Convention") will solve the problems described above. In the case where a Japanese person (the "collateral-giver") grants security over a Eurobond held by it, it will only be necessary to look at the governing law of the custody agreement between the grantor and its custodian for the purpose of perfection. The recipient of the security interest (the "collateral-taker") will no longer need to be concerned about whether or not the collateral securities are dematerialized or about the location of the collateral securities.

However, there are several issues that require further discussion[2]. The first issue is that the law governing the perfection of security interests over collateral securities may be different between the collateral-giver side and the collateral-taker side and may cause conflict problems. There is no explicit provision in the Convention. However, there was a general consensus at The Hague that the law controlling the custody relationship between the collateral-taker and its custodian should prevail and this interpretation of the Convention is expected to appear in its explanatory report[3].

The second issue which arises is that as a result of allowing different governing laws to apply to the same custodian with respect to the same kind of securities, there may be discrepancies depending on the governing law[4]. For example, with respect to an accountholder's recovery right in the case of bankruptcy of a Japanese custodian, an accountholder whose relationship is governed by New York law may enjoy a right of participation in relation to the securities owned by the custodian itself in addition to the assets held for accountholders (UCC 8-503 (a)), while an accountholder whose relationship is governed by Japanese law may only be able to look to the assets held by the custodian for accountholders. Is such result permissible under Japanese law? Is a different approach possible? A Japanese court would probably hold that such distribution right would be subject to the restrictions under Japanese insolvency law by finding that the law chosen under the Convention does not cover such aspect.

d. Short Review

The Japanese law on custody arrangements was devised and developed on the assumption that securities are always certificated. This is consistent with the idea that the paper represents the relevant rights and all the transactions should be made based on such paper. However, dematerialization of securities and the adoption of the book-entry system is now increasing and becoming more widespread e.g. the Bond, etc. Transfer Law.

Historically, indirectly held securities have been transferred by giving an instruction to the custodian (who was thought to have direct or indirect possession of the certificated securities). At that time people were generally unconcerned about whether perfection was made in conformity with the law of the location of the securities, because they could transfer or receive such securities through simply giving such instructions. However, in regard to the creation of the security interest such as a pledge over indirectly held securities practitioners have adopted a slightly different approach i.e. the strict application of the *lex situs* rule. We do not know the exact reason for this difference in approach given that from the owner's viewpoint, the transfer of securities and the creation of security interest over securities both amount to a disposal of some or all of the owner's rights in respect of the securities.

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[2] See generally, Morishita: "The Developments and Problems of the Legal System of the International Securities Settlement" 47 Sophia Law Journal (Vol. 3) 1 at 38.

[3] See Morishita, Footnote 2 at 40, and Hatama and Wanami: "The Outline of the Convention on the Law applicable to Certain Rights in respect of Securities held with an Intermediary" 1697 Commercial Law Journal (*Shoji houmu*) 83 at 86. Also see Hayakawa: "The Draft Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary" 1642 Commercial Law Journal 4 at 10.

[4] Morishita, Footnote 2.

In addition, the practitioners' characterization of indirectly held securities seems to have focused on to the protection of the final security holders' rights against the insolvency of the intermediaries. Before the settlement system of the book-entry JGBs (*Furiketsu-sai*) became subject to the current system under the Bond, etc. Transfer Law in 2003 the majority of practitioners took the view that each JGB holder had a co-ownership right in respect of JGBs kept by the Bank of Japan (the "BOJ") despite the variations of holding through intermediaries. The minority view was that each JGB holder simply had a contractual right against its custodian or the BOJ to demand delivery of the relevant JGBs.

However, the adoption of the Bond, etc. Transfer Law in relation to JGBs, which is a complete book-entry system rendered these arguments academic. Now the existence, transfer, and granting of security interest are all determined according to the book-entries. The Law also established a trust mechanism to cover loss incurred by any JGB holder in the case of the insolvency of the intermediaries (participants) of the JGB book entry system. At the same time this Law made it clear that the application of the *lex situs* was no longer practical for the cross-border transactions involving JGBs. Currently, the regulations of the book-entry JGBs are drafted on the assumption that creation of the security interest over the book-entry JGBs will be made pursuant to Japanese law but the wording can match with other governing law perfection mechanism once the Convention becomes operative.

As discussed in c. above, the Convention anticipates that different governing laws may apply to the collateral-giver and the collateral-taker depending on the governing law of each party's custody agreement with their respective custodian. Some academics may criticize such an approach on the basis that it would be simpler and more certain if only one law governed the situation. However, a binary approach in cross border transactions is not rare (think about cross product liability cases), and we believe the solution provided by the Convention should not create any serious problems.

e. Short Conclusion

The ratification of the Convention will have a major impact on the long standing policy of the Conflict of Laws of Japan, which is *lex situs*. Although the Convention will not provide complete legal certainty in the area of cross-border collateral transactions, we think it will give Japanese practitioners working in this area much clearer guidance and therefore will be welcomed by them. The ratification of the Convention and its implementation will also allow the Japanese legal framework to keep pace with market practice in the global custody arena.

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