

# CONFLICT OF LAWS – LAW AND REGULATION APPLICABLE TO SECURITIES ON THE BLOCKCHAIN

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**BLOCKCHAIN FROM A CENTRAL BANK  
PERSPECTIVES**  
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## INTRODUCTION

- **Robust legal and regulatory framework necessary condition for wholesale adoption of DLT-based financial instruments**
- **What law? what regulation?**
- **Overview**
  - Law governing property interests in DLT-based financial instruments
  - Territorial scope of application of securities regulation
  - Conclusions

## CONFLICT OF LAWS

- **Defining the issue:**
  - how to determine the law governing the creation and the perfection of property interests in DLT-based financial assets and their priority
  - Perfection: completion of steps necessary to render a transfer of coins/tokens effective against persons who are not parties to that disposition
  - Priority: more than one perfected property interest
    - perfection onchain vs. perfection offchain
    - Pledge vs. full-title security interest/outright disposition
    - Transferee vs. transferor's insolvency administrator

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## CONFLICT OF LAWS

- **From lex cartae sitae ...**
  - Location of (physical) certificate at the time of disposition
  - Dysfunctionality as a result of demobilisation and dematerialisation of securities
- **... to PRIMA**
  - Place of Relevant Intermediary Approach = location of securities account
    - § 8-110 UCC
    - EU Instruments:
      - Art. 9(2) Settlement Finality Directive (SFD)
      - Art. 9 Financial Collateral Directive (FCD)
    - Art. 4 Hague Securities Convention (HSC)

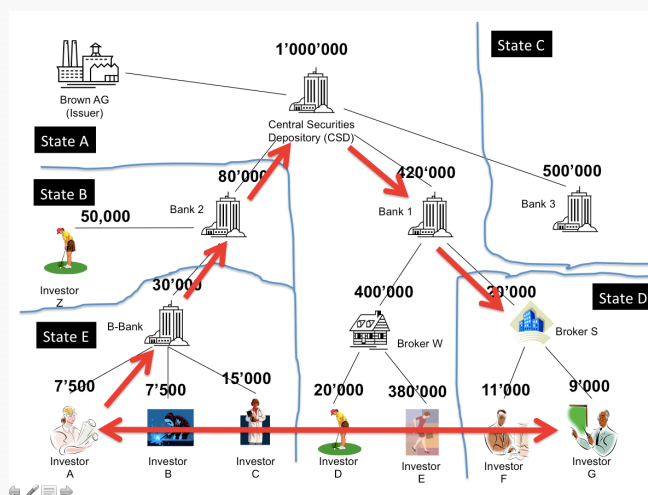
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## CONFLICT OF LAWS

- ... to PRIMA
  - Location of securities account
    - § 8-110 UCC
      - local law of the securities intermediary's jurisdiction (as expressly defined in an account agreement)
    - EU Instruments
      - Art. 9 II SFD:
        - "register, account or centralised deposit system located in a Member State"
      - Art. 9 FCD:
        - "country in which the relevant account is maintained"
    - Art. 4 HSC
      - law expressly agreed in account agreement +
      - Intermediary has a qualifying office in that state

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## CONFLICT OF LAWS



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## CONFLICT OF LAWS

- **PRIMA/HSC not applicable DLT-based securities**
  - Only permissioned DLT (“securities held with an intermediary”)
  - HSC is account based, DLT value based (token, coins) – analogy to direct holding of (physical) securities
  - DLT provides a complete and immutable record of ownership for each individual token -- requires application of one single law to whole chain of transactions

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## CONFLICT OF LAWS

- **Law designated by the system**
  - Art. 2(a) Settlement Finality Directive: “System” shall mean a formal arrangement:
    - between three or more participants ...
    - governed by the law of a Member State chosen by the participants; the participants may, however, only choose the law of a Member State in which at least one of them has its head office, and
    - designated as a system and notified to the Commission ...

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## CONFLICT OF LAWS

- **Primary rule: Law designated by the system**
  - Benefits
    - One single law covering all transactions recorded on a blockchain
    - Will often, but not always, coincide with law governing issuance of instrument
  - Introduces element of party autonomy in property law matters
    - Normally not accepted (but see Art. 4 HSC, Arts. 104, 105, 145 PILA – not effective against third parties)
    - Rationale: protection of third parties, i.e. persons who are not a party to the disposition/not bound by the choice of law
    - Only users can acquire property interests in DLT-based securities
    - No „third parties“ which could be put at a disadvantage as a result of a choice of law

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## CONFLICT OF LAWS

- **Fallback rule: Law governing the issuance of securities**
  - Law chosen by the issuer (debt securities); law at the place of incorporation/principal place of business (equity securities)
  - Benefits
    - One single law covering all transactions on a blockchain (including issuance, corporate action)
  - Disadvantages
    - Pools of securities from different issuers
    - Requires distinction between debt and equity securities
    - Requires determination of issuer's location (in case of equity securities)

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## REGULATION

- **Issues**

- How is regulatory regime applied to DLT networks?
  - Substantive scope of regulations – e.g. are tokens or coins securities?
- What is personal/territorial scope of regulatory regimes?
  - Regulation is administrative law – applicable only if case has a relevant connection to territory of regulating state
- How is financial sector regulation enforced if financial services are provided through a DLT network?
  - Permitted vs. unpermitted DLT
  - ESMA: “...the DLT that is likely to be used in financial markets would be a permitted system with authorized participants only.”

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## REGULATION

- **Territorial scope of regulations – nexus to territory of regulating state**

### PRESENCE WITHIN TERRITORY

- Location of issuer
- Location of users
- Location of service providers

### EFFECT WITHIN TERRITORY

- Competition law – US vs. Alco, 148 F.2d 416 (1945); ECJ, 27.9.1988 – 89/85 - wood pulp
- direct
  - foreseeable
  - substantial

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## REGULATION

**SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 / July 25, 2017, p 18:**

economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

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## CONCLUSIONS

- **Issuance/trading/clearing & settlement of securities on distributed ledger promising use case**
- **Robust legal and regulatory framework, including clarity as to which law/regulation applies, necessary condition**
- **PRIMA not an adequate solution for determining the law governing creation and perfection of property interests in DLT-based securities**
- **Better (tentative) approach**
  - Law designated by the system
  - Law governing the issuance of securities
- **Further work and research needed**
  - Technical evolution - Development of ecosystem
  - Legal evolution
  - Agenda item for Hague Conference for Private International Law, Financial Stability Board

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