

Hague Securities Convention goes into effect in the United States

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Abstract

Purpose – *To explain the Hague Securities Convention in the context of secured financing transactions in the US and to discuss the implications of the Convention on new and existing transactions, as well as on market practice going forward.*

Design/methodology/approach – *This article provides a broad overview of the Hague Securities Convention and the impact of the Convention's choice of law rules on secured financing transactions in the US involving intermediated securities, including how this deviates from previously applicable laws (such as the Uniform Commercial Code), and provides practical considerations with respect to secured financing transactions.*

Findings – *While in most circumstances the Convention provides for the same choice of law as previously applicable laws, there are certain scenarios where the Convention will produce a different result. Market practice with respect to perfecting security interests will likely change to take account of the Convention and to provide the parties with certainty regarding the law applicable to secured transactions.*

Practical implications – *The Convention calls for increased diligence with respect to the law governing the account agreement between the debtor and the securities intermediary and whether the securities intermediary has a qualifying office in that jurisdiction.*

Originality/value – *Practical guidance from experienced finance lawyers.*

Keywords *Choice of law, Hague Securities Convention, Intermediated securities, Perfection, Security interest, Uniform Commercial Code*

Paper type *Technical paper*

Most interests in securities and other financial assets are held indirectly through securities accounts with financial institutions acting as intermediaries. On April 1, 2017, the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, more commonly referred to as the Hague Securities Convention (the "Convention")^[1], came into effect in the United States. The Convention provides rules for choosing which country's substantive law applies to certain issues for the indirect holding of securities and other financial assets with an intermediary. Notably, those issues include perfection and priority of security interests. In some cases the substantive law chosen by the Convention rules for those issues will differ from (and as a treaty, preempt) the substantive law chosen by existing Uniform Commercial Code (UCC) choice of law rules.

The Convention applies to all transactions with a choice of law issue within its scope, whether entered into before or after the April 1, 2017, effective date. Even in transactions in which parties currently are all US entities and no non-US laws are implicated, the Convention's rules should be considered as its rules can become applicable if certain choice-of-law issues arise during the life of a transaction, as discussed in more detail below.

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Discussion

Background and scope of the Convention

The Convention was promulgated in 2006 by the Hague Conference on Private International Law[2] and was signed by the United States in 2006, although it was not ratified by the United States until December 2016. Pursuant to its terms, the Convention became effective in the United States (as well as in the two other countries party to it, Mauritius and Switzerland) on April 1, 2017[3]. The Convention now applies in the United States to any transaction within its scope, including any such transaction involving any non-US entity (not just non-US entities from the other countries that are party to the Convention). Transactions within its scope include “all cases involving a choice of law between the laws of different States” (i.e., countries) with respect to the perfection and priority of a security interest in securities credited to a securities account through a securities intermediary.

While the Convention is broadly applicable to transactions within its scope, that scope is in some respects quite narrow. First, as stated above, it is solely a choice of laws regime – it does not contain any substantive law. With a few (although important) exceptions, the Convention disregards other choice of law rules (in legal parlance, no *renvoi*). Once the Convention’s rules have been applied to identify which country’s law governs, that country’s substantive law applies and there is no further application of the Convention. Second, the Convention applies only to securities[4] indirectly held in a securities account with an intermediary; it does not apply to directly held securities or to assets that would not be considered securities (such as cash).

However, for transactions that fall within this scope, the Convention determines the law applicable to an important set of issues, including (i) the nature and effects of rights acquired in the indirect holding of securities; (ii) the nature and effects of a disposition or transfer of such securities or an interest in such securities, including perfection and priority of a security interest in a security entitlement or a securities account; and (iii) requirements for exercising remedies against such securities[5].

The Convention specifically excludes from its scope (i) “the rights and duties arising from the credit of securities to a securities account to the extent that such rights or duties are purely contractual or otherwise purely personal”, (ii) the contractual rights and duties of parties to a disposition and (iii) the rights and duties of an issuer of securities or its registrar or transfer agent[6]. One important consequence of the general exclusion of contractual rights is that aspects of the creation of a security interest may not be within its scope (as opposed to the perfection or priority of a security interest).

The Convention’s choice of law rules

Article 4 of the Convention sets forth the “Primary Rule” for determining choice of law: “The law applicable to all the issues specified in Article 2(1) is the law in force in the [country] expressly agreed in the account agreement as the [country] whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law”[7]. Under the Primary Rule, the parties to the account agreement (e.g., the account holder and the securities intermediary) can select the desired applicable law by including in the account agreement either: (i) a provision specifying the governing law for the entire account agreement, in which case such law would also be the applicable law for all issues within the scope of the Convention or (ii) a separate provision expressly specifying the governing law for all issues within the scope of the Convention, in which case such law would be the applicable law for all issues within the scope of the Convention, even if a different law governs the remainder of the account agreement. The provision specifying the governing law must be included in the account

agreement to be applicable. (That, of course, could be accomplished by an amendment to the account agreement^[8]).

This Primary Rule resembles the UCC perfection choice of law rules, which allow the parties to specify the applicable perfection law by agreeing on the “jurisdiction” of the securities intermediary for purposes of the securities account and the UCC. But the Convention adds a significant constraint on that ability of the parties to choose the applicable perfection law. This constraint is commonly referred to as the “qualifying office” test. It requires the securities intermediary to have, at the time the parties chose the applicable perfection law in the account agreement, an office in the designated country. To qualify, that office must be one that “(a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another [country] – (i) effects or monitors entries to securities accounts; (ii) administers payments or corporate actions relating to securities held with the intermediary; or (iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts; or (b) is identified by [a][. . .] specific means of identification as maintaining securities accounts in that [country]”^[9].

It is interesting to note that the office that satisfies the “qualifying office” test for the securities intermediary does not need to be the same office handling the securities account in question. The Convention also provides that, in applying the “qualifying office” test, activities that are generally administrative in nature would not suffice to meet the “qualifying office” test.

With some important consequences for their application in the United States, the Convention’s rules employ the concept of a “Multi-unit State”. The United States, with its territorial “units” of states, the District of Columbia, Puerto Rico and other subordinate units, is a Multi-unit State^[10].

One area where the concept of a “Multi-unit State” is relevant is the “qualifying office” test. If the parties choose the law of any subunit of the United States (e.g., the State of New York), the “qualifying office” test can be satisfied by an office anywhere in the United States, not just in New York.

A second key area where the “Multi-unit State” concept is relevant is perfection by filing. If the parties choose the law of a subordinate unit of a Multi-unit State to govern a securities account, the Convention’s rules will respect the perfection choice of law rules of that subordinate unit if those choice of law rules identify the substantive law of another subordinate unit in the same Multi-unit State to govern perfection by filing.

For example, if the parties choose New York law to govern a securities account and the debtor/account holder of the securities account is a Delaware corporation, New York’s UCC perfection choice of law rules (and so, the Convention’s) would look to Delaware law for perfection by filing of a security interest in the securities account. This aspect of the Convention’s rules results in their reaching the same result as the UCC filing perfection choice of law rules in most cases.

If the account agreement fails to designate a governing law and/or if the “qualifying office” test is not met, the Convention also provides “Fall-back Rules” to help determine the governing law. These Fall-back Rules generally refer to the intermediary to determine the applicable law (e.g., the location of the office of the intermediary; the law of its jurisdiction of organization; or the law of its place of business or, if it has more than one place of business, principal place of business). The Convention lists certain factors to be disregarded in determining applicable law, including the jurisdiction of the issuer of the securities, the place where certificates evidencing the securities are located or the place where a register is maintained.

Transition

There is no transition period or grandfathering of existing transactions under the Convention. As of April 1, 2017, it applies to all agreements within its scope, regardless of when executed.

The Convention's rules include a transitional element regarding the parties' agreement as to the governing law. For new transactions, the governing law provision needs to cover all of the issues within the Convention's scope^[11]. But for governing law provisions in account agreements executed prior to April 1, 2017, the Convention will accept a governing law provision that covers any of the issues within the Convention's scope and apply it to all the issues within the Convention's scope so long as the "qualifying office" test is met. [The effect of this rule is unclear in a situation where a governing law clause in an existing account agreement selects one governing law for one Article 2(1) issue (e.g., perfection) and a different governing law for a different issue (e.g., foreclosure)].

Applicability of the UCC

As a treaty, the Convention will preempt inconsistent UCC provisions. However, so long as the "qualifying office" test is met (i.e., so long as the securities intermediary has a "qualifying office" in any US state), the parties to a secured transaction may continue to specify the law of a particular US state to govern perfection of a security interest in a securities account by agreeing that all issues as to the securities account (or at least all issues within the Convention's scope) will be governed by the desired US state law. As mentioned, the Convention's respect of filing perfection choice of law rules within a Multi-unit State will result in the same law applying in most cases under both UCC and Convention rules.

A case in which the Convention's rules may have a different outcome than the UCC is that of a non-US debtor/account holder that is treated as "located" for UCC filing perfection choice of law purposes outside the United States. For example, an Ontario corporation with its chief executive office in Ontario may be treated under the UCC filing perfection choice of law rules as "located" in Ontario because Ontario has a public security interest recordation system similar to the UCC that likely meets the standard of UCC Section 9-307. The UCC perfection choice of law rules would therefore look to Ontario for perfection by filing or registration. However, as stated above, the Convention's rules start with the law chosen by the parties (e.g., New York) but disregard the chosen country's filing perfection choice of law rules if they lead to a jurisdiction outside the Multi-unit State. Here, Ontario is outside the United States, so the Convention's rules would not respect the New York UCC filing perfection choice of law rules. Instead, per the Convention's rules, perfection by filing would be governed by the chosen law (New York) and call for a UCC filing in New York. In such a scenario, it may be advisable to file in both the foreign jurisdiction and the jurisdiction governing the account agreement.

Practical considerations

With respect to US transactions, the Convention could be implicated when any of the following are located in a non-US country: (i) the account holder, (ii) an issuer of any of the securities, (iii) any party to a transfer of the securities, (iv) any intermediary, (v) the location of security certificates or (vi) an adverse claimant. Given that a non-US adverse claimant or a succeeding or additional party can become involved in the transaction following the execution of a transaction, parties entering into transactions secured by indirectly held securities and securities accounts should take the Convention into account in documenting the desired choice of law and in perfecting security interests. Also, as the Convention is not applicable to deposit accounts, transactions secured by both deposit accounts and securities accounts may require perfection of those security interests in multiple jurisdictions.

New transactions

If the desired law for a secured transaction – including perfection of any security interest thereunder – is the law of a US state, as is the case for many financing transactions, then the Convention will likely result in at least the following changes in practice (with respect to transactions within its scope):

- The governing law of the account agreement (or, if not the entire account agreement, then with respect to the issues referred to in Article 2(1) of the Convention) will specify such desired law. This is in addition to specifying the securities intermediary's UCC "jurisdiction" within the account control agreement.
- The parties may want to obtain evidence that the securities intermediary has, when the account agreement is entered into, an office in the United States engaged in the business or other regular activity of maintaining securities accounts.
- The jurisdiction(s) for UCC filings may need to change and/or additional UCC filings may be made (e.g., as discussed above if the debtor is a non-US entity).

Existing transactions

As mentioned above, the Convention applies to all transactions within its scope, including transactions entered into prior to April 1, 2017, and transactions with no connection to any other country that has adopted the Convention. A few scenarios that may implicate the Convention for existing transactions, and which may require further analyses, include: (i) failure of the securities intermediary to meet the "qualifying office" test (based upon either (x) the securities intermediary not having a "qualifying office" or (y) an inability to determine whether the securities intermediary had a "qualifying office" at the time the account agreement was entered into), (ii) perfection by control or filing where a non-UCC law governs the account agreement and (iii) perfection by filing under the UCC where the debtor is located outside the United States.

Opinion practice

Law firms providing opinions with respect to perfection of security interests in securities accounts will need to consider how to reflect the new choice of law rules under the Convention.

Notes

1. For the text of the Convention, see www.hcch.net/en/instruments/conventions/full-text/?cid=72
2. The Hague Conference on Private International Law (HCCH) is an 82-member organization that works for the "progressive unification" of private international law. The HCCH became a permanent inter-governmental organization at the Hague in 1955. For more information, see www.hcch.net/en/about
3. The Convention became effective in all three adopting countries on the first business day after the three-month period following submission of the instrument of ratification by the third adopting country, the United States (which submitted its instrument of ratification to the Netherlands on December 15, 2016). Unlike most other Hague conventions, adoption of the Convention is open to both Member States of the HCCH and non-Member States (which was done intentionally to facilitate broad adoption of the Convention). The European Commission recommended in December 2003 that its member states sign the Convention, but that recommendation was later withdrawn. For countries inside and outside the EU that have not adopted the Convention, issues related to what law applies in cross-border securities transactions continue to be debated.
4. The definition of "securities" in the Convention is intentionally broad "so as to accommodate changes in market practice[. . .][and] if an asset is of a kind credited to a securities account and is financial in nature it is a security within the meaning of the [Convention]". See Explanatory Report

on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the “Explanatory Report”), Comment 1-2.

5. See Article 2(1) of the Convention and Article 2 of the Explanatory Report.
6. See Article 2(3) of the Convention.
7. See Article 4(1) of the Convention.
8. Such amendment to the account agreement may be included in an account control agreement, in which case the relevant language should specifically state that the account agreement is being amended.
9. See Article 4(1) of the Convention.
10. See Article 1(1)m) of the Convention for the definition of “Multi-unit State”.
11. See Article 2(1) of the Convention for the full list of issues within the Convention’s scope.

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