

# Client Alert

March 2017

## The Hague Securities Convention Affecting Securities Held in Securities Accounts, Including Perfection and Priority

Effective on April 1, 2017, the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the **Convention**) will become effective in the United States. The Convention will, as the federal law of the United States, apply to determine the choice of law relating to certain matters concerning securities held in securities accounts, including, among other things, the law affecting perfection and priority of security interests in securities held in securities accounts. In transactions in which only US entities are involved and US law governs the agreements, the Convention will not apply (Article 3).

### What is the Rule?

The Convention contains a primary rule and three fallback rules. If the primary rule under Article 4 of the Convention does not apply, then one of the fallback rules under Article 5 of the Convention will be applied.

The **primary rule** states that the applicable law regarding all Article 2(1) matters, as such matters are described below, is (a) the law in force in the State<sup>1</sup> expressly agreed by the parties in the account agreement<sup>2</sup> as the jurisdiction whose law governs the account agreement or (b) if the account agreement expressly provides that the law of another jurisdiction applies to the Article 2(1) matters, that law applies. The primary rule applies **ONLY** if the intermediary has, at the time of the account agreement, an office<sup>3</sup> (a **Qualifying Office**) in the specified State 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 State:
  - (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

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<sup>1</sup> "State" means a sovereign nation and includes territorial units of a Multi-unit State where applicable. "Multi-unit State" means a State 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 issues specified in Article 2(1). For example, the United States is a State that is a Multi-unit State where each state in the United States is a territorial unit.

<sup>2</sup> "Account agreement" means the agreement with the relevant intermediary that governs the securities account. This does NOT include any related securities account control agreement, unless that control agreement also governs the security account or expressly amends the account agreement.

<sup>3</sup> I.e., the place of business at which any of the activities of the relevant intermediary are carried on. Administrative places of business, such as bookkeeping, data processing or call centers, will not alone meet the standard for existence of an office in the chosen State for purposes of the primary rule.

(b) is identified by an account number, bank code or other specific means of identification as maintaining securities accounts in that State.

If the primary rule does not apply (because the intermediary does not satisfy the Qualifying Office requirement or the agreement does not state a governing law) the **fallback rules** specify that the applicable law will be (in sequence of priority of application):

(1) the law of the jurisdiction<sup>4</sup> of the office that the account agreement “expressly and unambiguously” states as the office of the relevant intermediary through which it entered into the account agreement (Art. 5(1));

(2) the law of the jurisdiction of incorporation or organization of the relevant intermediary at the time the account agreement is entered into or, if no account agreement exists, at the time the securities account was opened (Art. 5(2)); or

(3) the law of the jurisdiction in which the relevant intermediary has its place of business or, if it has more than one place of business, its principal place of business (Art. 5(3)).<sup>5</sup>

### What Areas of Law Does the Rule Affect?

Article 2(1) of the Convention specifies that its choice of law rules apply to only the following matters in respect of securities held with an intermediary:

(a) the legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account;

(b) the legal nature and effects against the intermediary and third parties of a disposition<sup>6</sup> of securities held with an intermediary;

(c) the requirements, if any, for perfection of a disposition of securities held with an intermediary;

(d) whether a person’s interest in securities held with an intermediary extinguishes or has priority over another person’s interest;

(e) the duties, if any, of an intermediary 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;

(f) the requirements, if any, for the realization of an interest in securities held with an intermediary; and

(g) whether a disposition of securities held with an intermediary extends to entitlements to dividends, income or other distributions, or to redemption, sale or other proceeds.

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<sup>4</sup> For purposes of each of the fallback rules, the jurisdiction is a State or a territorial unit of a Multi-unit State.

<sup>5</sup> Roy Goode, Hideki Kanda and Karl Kreuzer, with the assistance of Christophe Bernasconi, *Explanatory Report On The Hague Convention On The Law Applicable To Certain Rights In Respect Of Securities Held With An Intermediary*, Paragraph Int-62, page 23.

<sup>6</sup> “Disposition” means any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or nonpossessory.

**Takeaways:**

1. If the Convention applies, it will apply the law of the applicable jurisdiction to all of the above matters and the parties cannot pick and choose the laws of different jurisdictions for different matters on the list. The Convention provides choice-of-law rules but not substantive law.

2. The Convention determines the law to apply concerning perfection, but not to creation, as between the debtor and the secured party, of the security interest in securities held in a securities account.

3. Because the Convention determines the law applicable to perfection and since a security interest in securities entitlements can be perfected by control or by filing a financing statement, when relying on filing alone to perfect, it is important to determine if the Convention rules change the pre-Convention expected outcome.

4. The Convention determines the law to apply concerning the power to sell or dispose of securities in a securities account, for example upon a default.

5. For the United States, which is a "Multi-unit State," the primary rule will apply to an account agreement that chooses a governing law of any territorial unit (i.e., a state such as New York or Texas) of the United States so long as the intermediary has a Qualifying Office located somewhere in the United States. The Qualifying Office need not be located in the chosen territorial unit but can be located in another territorial unit of the United States.

**What About Transactions Entered Into Prior to April 1, 2017?**

The Convention contains transition provisions in Article 16. The transition rules are designed to apply the rules of the Convention to pre-April 1, 2017, securities accounts. If, however, the related account agreement, whether by amendment or otherwise, expressly specifies that the Convention applies, then the primary and fallback rules apply and not the transition rules.

The **transition rules** are:

1. If the account agreement expressly provides that the Convention applies, then the primary rule, or fallback rules, as applicable, will apply.

2. If the account agreement does not expressly provide that the Convention applies, but the agreement expressly provides that the law of a specified State (or a territorial unit of a specified Multi-unit State) applies to any of the matters described in Article 2(1) of the Convention, then that specified State's (or unit's) law will apply to all matters described in Article 2(1) of the Convention; however, this transition rule applies **ONLY** if the intermediary has, at the time of the account agreement, a Qualifying Office in the specified State (or Multi-unit State).

3. If the account agreement neither expressly provides that the Convention applies nor expressly provides that the law of a specified jurisdiction applies to any of the matters described in Article 2(1) of the Convention, but the agreement provides that the securities account is maintained in a specified State (or a territorial unit of a specified Multi-unit State), then the law of that State (or unit thereof) will apply; however, this transition rule applies **ONLY** if the intermediary has, at the time of the account agreement, a Qualifying Office in the specified State (or Multi-unit State).

NOTE that if the intermediary did not, at the time of the account agreement, have a Qualifying Office in the applicable specified State (or Multi-unit State), then the Convention still applies. This would result in

the fallback rules' applying. Therefore, it may be important to review pre-April 1, 2017, transactions involving securities accounts to determine which rule will apply and whether the parties' desired outcome would apply under the law selected by the Convention.

### **Some Examples of the Effects of the Convention.**

1. *Account Agreement vs. Securities Account Control Agreement.* Securities accounts are governed by one or more written account agreements and security interests in securities entitlements and securities accounts are typically governed by a separate securities account control agreement. It is typical for the securities account control agreement to state either that such agreement is governed by New York or another state's law or that the state of New York or another state is the securities intermediary's jurisdiction for purposes of the Uniform Commercial Code. Additionally, it is often typical for the related account agreements to choose the law of a different state's law, for example, the law of the state of Minnesota, as the law governing the account agreement or the securities account. Since the Convention specifies that the account agreement is what is looked to for purposes of applying the rules of the Convention, if the account agreement specified that the law of the state of Minnesota governed the account agreement or the account, then the law of the state of Minnesota would be applied for purposes of determining perfection of the security interest in the related securities entitlements and securities account, which would not be the intent of the parties as evidenced by the provision in the securities account control agreement.

In such a case, if the parties want New York law to apply, the account agreements (not the securities account control agreement) would need to provide (or be amended to provide) that "the law of the state of New York is applicable to all issues specified in Article 2(1) of the Hague Securities Convention." Alternatively, the securities account control agreement could provide that "the [intermediary] and the [account holder] agree that the [account agreement] is hereby amended to provide that the law of the state of New York is applicable to all issues specified in Article 2(1) of the Hague Securities Convention."

2. *US Debtor and Non-US Account Agreement.* In cases involving a US debtor and a non-US law-governed account agreement (for example, a Texas corporation entering into an English law-governed account agreement), assuming that the Convention specifies that English law will apply, then perfection is governed by English law and not by Texas law (i.e., UCC §9-307(c)(1) does not apply). Nevertheless, in this case the parties may determine that a filing be made in accordance with the provisions of the Texas Uniform Commercial Code.

3. *Non-US Debtor and US Account Agreement.* In cases involving a non-US debtor and a US law-governed account agreement (for example, a Canadian corporation formed in Ontario entering into a New York law-governed account agreement), assuming that the Convention specifies that New York law will apply, then perfection is governed by New York law and not by Ontario law, even though the law of Ontario might satisfy the requirements of UCC §9-307(c), in that it has a filing system for the recordation of security interests in personal property. Again, in this case the parties may determine that a filing be made in accordance with applicable Ontario law.

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