

# BUSINESS LAW TODAY

## Changes in the Choice-of-Law Rules for Intermediated Securities: The Hague Securities Convention Is Now Live

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Lawyers working in the commercial law field are familiar by now with the choice-of-law rules for transactions in intermediated securities provided by Articles 8 and 9 of the Uniform Commercial Code (the UCC). Those rules, appearing principally in certain subsections of UCC §§ 8-110 and 9-305, have functioned well as a matter of U.S. law in international as well as domestic transactions, but they have now been augmented and partially preempted by the Hague Securities Convention (the Convention), more formally known as the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

The Convention, ratified by the United States in December 2016, became effective as a matter of U.S. federal law on April 1, 2017. Fortunately, the Convention's choice-of-law rules lead in most instances to the same results as under Articles 8 and 9. There are some differences, however, and the Convention applies even to existing transactions.

### Background and Scope of the Convention

The Convention was promulgated in 2006 by the Hague Conference on Private International Law. By its terms it became effective

upon adoption by three nations, and the United States is the third of those nations—the other two to date being Switzerland and Mauritius. More countries are expected to follow, and as the Convention's choice-of-law rules become internationally widespread, the transactions to which the Convention applies will be greatly facilitated.

The Convention applies only to transactions in intermediated securities, which U.S. lawyers often call the “indirect holding system.” In such transactions, the securities' registered owner is typically a clearing corporation (e.g., a federal reserve bank, the Depository Trust Company, Clearstream, or Euroclear); the clearing corporation maintains accounts reflecting that the securities are held for the benefit of a bank, broker, or other securities intermediary (referred to in this article as an “intermediary,” although a clearing corporation acts in this role as well with respect to their participants); and the securities' ultimate beneficial owner may be a customer of the intermediary. When a customer says that he, she, or it owns securities issued by Social Media Corporation, the customer in the indirect holding system actually has a right to the securities against the intermediary, and the intermediary has

a right to the securities against the clearing corporation. In the United States, the substantive commercial law rules governing these relationships are set forth in Part 5 of UCC Article 8. Naturally, other nations' substantive rules can and do differ substantially.

The Convention determines the applicable law for a broad range of commercial law issues in any transaction or dispute “involving a choice” between the laws of two or more nations. In this globalized era, transactions in intermediated securities frequently present such a “choice” for purposes of the Convention, for example whenever any two of the following elements of the transaction are in different nations: the account holder; an intermediary; any party to an outright or collateral transfer; an adverse claimant; a clearing corporation; a creditor of either the account holder or an intermediary; the issuer; or the certificates held by the clearing corporation. (U.S. lawyers have generally never ignored elements such as the debtor's location or the other elements just mentioned, for purposes of planning with respect to the likely jurisdictions of a possible insolvency proceeding, but they have also been accustomed to treating these elements as immaterial to a strictly UCC choice-of-law

analysis under §§ 8-110 and 9-305.) Moreover, any non-U.S. nation in question need not be a party to the Convention in order for the Convention to apply. As a result, lawyers should keep the Convention in mind in planning virtually every intermediated securities transaction.

The choice-of-law issues determined by the Convention include all of those currently covered by UCC §§ 8-110 and 9-305, as well as a few others. The Convention's issues, set forth in its Article 2(1), include all of the following:

- the rights and obligations between a customer and its intermediary;
- the perfection steps that must be taken if a customer grants a security interest to the intermediary or to a third-party lender;
- whether the transfer of an interest in securities is characterized as a sale or a security interest;
- the effect of a judgment creditor of the customer attaching or levying on the customer's interest in the securities;
- how the priority conflict among buyers, secured parties, and judgment lien creditors is resolved if more than one of them claims an interest in the securities;
- the effect of a disposition of the securities by the intermediary, with or without the customer's consent;
- whether any interest in the securities obtained by a buyer, secured party, or judgment lien creditor extends to dividends and other distributions; and
- the requirements that a secured party or other acquirer must follow in foreclosing on or otherwise realizing the value of the securities.

Several limitations on the Convention's scope should also be noted. The Convention provides choice-of-law rules only for indirectly held securities, not for directly held ones. The Convention's rules do not affect the rights and duties of a security's issuer or transfer agent. The Convention also does not provide choice-of-law rules for purely contractual issues, for example, the effect of an arbitration clause in the agreement governing the account (the account agreement), or

the strictly bilateral, rather than third-party, effects of attachment of a security interest.

It is important to note the differences between basic terms such as "securities" as used in the Convention and the same terms as used in UCC Article 8. The Convention defines the term "securities" as "any shares, bonds or other financial instruments or financial assets (other than cash) or any interest therein." This definition is broader in some respects than the UCC Article 8 definition, yet the Convention's overall reach is narrower than that of the UCC's indirect holding system. This is because UCC § 8-102(a) (9) permits the intermediary and customer to agree that any property other than securities will also be treated as a "financial asset" to which the indirect holding system will apply. By contrast, the Convention contains no such option for expanding its scope by agreement. (The Convention uses "financial asset" as part of its definition of "security," but does not define "financial asset.") Similarly, the UCC's indirect holding system clearly applies to "cash" (i.e., credit balances), either because credit balances are considered part of the securities account itself, or because the intermediary and customer have agreed to treat the cash as a financial asset, but the Convention expressly excludes cash even if the cash would otherwise have been considered a "financial asset" within the Convention's usage of that term. Nonetheless, the Convention is designed like the UCC to be flexible and to have fluidly broad coverage that will meet the demands of market practices. An authoritative and in-depth [Explanatory Report](#) on the Convention, referring to "exchange traded financial futures and options" and to "credit default swaps" suggests that securities held with an intermediary for purposes of the Convention could encompass some assets that might be considered commodity contracts or otherwise not considered securities or other financial assets under the UCC.

### The Importance of Unified Transnational Choice-of-Law Rules: An Example

Suppose that a bank operating in New York acts as an intermediary, and that one of the bank's custodial customers is a corporation

organized under Texas law. The customer wishes to invest in securities of a certain issuer located in Ruritania, so the intermediary acquires those securities through a clearing corporation and credits them to the customer's account. A German lender extends credit to the customer, is granted a New York law security interest in the customer's Ruritanian securities as collateral, and takes appropriate steps under New York law to perfect the security interest. Later, an Australian unsecured creditor of the customer obtains a judgment against the customer and also obtains a judgment lien on the customer's interest in the securities.

The substantive outcome of the contest between the German lender and the Australian creditor will often depend on the choice-of-law rules of the forum in which the contest arises. In a New York forum, prior to effectiveness of the Convention—and generally now as well, although some details are discussed below—the German lender has generally prevailed if it has perfected under the substantive law made applicable by New York's conflicts rules. Under those conflicts rules, if the account agreement designates, say, New York or New Jersey as the "securities intermediary's jurisdiction" or, absent such a clause, provides that the account agreement is governed by New York or New Jersey law, then the lender may perfect by control under New York or New Jersey law, as the case may be. See NYUCC §§ 9-305(a)(3), 8-110(e). Also under New York's conflicts rules, the fact that the customer is a Texas corporation means that the lender may perfect by filing a financing statement under the substantive law of Texas. See NYUCC §§ 9-305(c)(1) and 9-307(e). If perfected by either means, the German lender prevails under the applicable state's version of UCC § 9-317(a)(2)(A).

Very different rules would likely apply if the Australian creditor brings its action in Ruritania. The Ruritanian court could very well apply a widespread choice-of-law rule known as *lex rei sitae*, which points to the substantive law of the asset's situs—and Ruritanian law could very well view securities issued by a Ruritanian issuer as being located in Ruritania. Moreover, under

Ruritanian substantive law, a judgment lien of the Australian creditor could very well take priority over the German lender's security interest if the German lender had not previously taken steps to perfect under Ruritanian law, rather than New York or Texas law. A similar scenario would arise if the Ruritanian choice-of-law rules viewed the securities as being located in, say, Sylvania, where the clearing corporation were located or where certificates representing the securities were physically held.

This problem can be especially acute under insolvency law. In a Ruritanian insolvency proceeding, the lender's security interest may not be recognized at all, if the applicable substantive law is that of Ruritania or another jurisdiction in which the lender did not take appropriate perfection steps.

A similar issue could even affect the lender if the customer becomes a debtor under the U.S. Bankruptcy Code. In such a proceeding, the bankruptcy trustee would have the status of a hypothetical creditor with a judgment lien on the customer's Ruritanian securities, obtained at the time of the commencement of the bankruptcy case. What is the choice-of-law rule that determines the substantive effects of this hypothetical creditor's judgment lien? The Bankruptcy Code does not expressly provide such a choice-of-law rule, nor does the case law appear to be well-settled. If the substantive effects are determined by Ruritanian law, then the bankruptcy trustee could set aside the lender's security interest and treat the lender as a general secured creditor, even though the security interest would have been senior to the judgment lien under New York's substantive law.

The importance of all of the foregoing is multiplied for lenders that extend credit against a portfolio of securities of issuers located, or held through clearing corporations, in numerous countries. Without a clear and widely unified choice-of-law rule in these circumstances, it could easily become cost prohibitive for a lender to investigate and comply with the substantive laws that might apply under the choice-of-law rules of each country in which litigation might be brought. Conversely, the more

widely adopted the Convention becomes, the more the parties contemplating a transaction can be confident that its broad set of issues will be resolved under a single body of substantive law, known in advance, irrespective of the forum in which a dispute is likely to arise. The prospect of approaching this goal—in a manner that also harmonizes well with the sound, existing rules of UCC Articles 8 and 9—is what led the American Bar Association, the Association of Global Custodians, the International Swaps and Derivatives Association, EMTA (formerly the Emerging Markets Traders Association), the Securities Industry and Financial Markets Association, and the Uniform Law Commission all to support U.S. ratification of the Convention.

#### The Convention's Strong Kinships with UCC Articles 8 and 9

The Convention's primary rule, set forth in its Article 4(1), provides that the law applicable to all of the choice-of-law issues covered by the Convention is the law chosen by the intermediary and its customer to govern their account agreement generally or, alternatively, to govern the issues covered by the Convention specifically. The only limitation, often referred to as the "Qualifying Office" test and further discussed below, is that this chosen law must be that of a country in which the intermediary, at the time that the parties enter the agreement, has an office that is engaged in the activity of maintaining securities accounts.

Many readers will already see that by giving effect to the account agreement's governing-law clause, the Convention is directly parallel to UCC § 8-110(e)(2). By the same token, the Convention's giving effect to an alternative clause, in which the parties designate a body of law different from the one that governs the account agreement as a whole, is directly parallel to UCC § 8-110(e)(1). The agreement between an intermediary and its customer is always at the essence of the customer's interest in intermediated securities, and this is the reason that the Convention, just like UCC Articles 8 and 9, looks at this agreement in determining the applicable choice of law.

We offer one word of caution, however. UCC § 8-110(e)(1) and (2) refer to "an agreement" between the intermediary and its customer governing the account, whereas the Convention's definition of account agreement refers to "the agreement" between those parties governing the account. The [Explanatory Report](#) makes clear that this agreement may consist of more than one document. However, it is probably advisable to avoid relying on the law designated only in a free-standing control agreement, i.e., one that is not clearly a part of the account agreement per se, unless the control agreement makes clear that it is amending the account agreement.

The Convention also generally disapplies the conflict-of-laws notion of *renvoi*, in which a forum would have to take account not only of another jurisdiction's substantive law, but also of the other jurisdiction's conflicts-of-law rules. Thus, under the Convention Article 10, if the parties have designated, for example, English law, then a U.S. forum would apply English substantive law without regard to England's own conflicts rules. This treatment of *renvoi* also parallels UCC Articles 8 and 9, which express the same idea by designating the "local law" of the jurisdiction in question.

Also directly paralleling the UCC, for lenders that seek to perfect a security interest by the filing of a financing statement, the Convention generally does a remarkably good job of accommodating UCC Article 9's choice-of-law rules for perfection by filing. See Convention Article 12(2)(b), further discussed below.

Applying all of these points to the earlier example of the New York intermediary and its Texas customer owning Ruritanian securities, a New York forum will reach exactly the same results under the Convention as heretofore under the UCC alone (assuming only that the Qualifying Office test is met; see below). If the German lender seeks to perfect its interest by control, and if the account agreement designates New York or New Jersey law as either the account agreement's own governing law or as the law governing the Convention's Article 2(1) issues, then control will be available

under New York or New Jersey law, as the case may be. Alternatively, if the German lender seeks to perfect its interest by filing, then the Convention will take account of New York's enactment of UCC §§ 9-305(c) (1) and 9-307, which enable perfection by the filing of a financing statement in Texas.

### The Convention's Principal Differences from UCC Articles 8 and 9

There are a few minor instances in which the choice-of-law outcomes under the Convention might differ from those under UCC Articles 8 and 9 alone. The most important of these are described here, but the risk of a different outcome in any of these circumstances is manageable by sound transactional planning. In the case of transactions already in place before the Convention becomes effective, some transitional attention may be required.

#### Qualifying Office

The Convention's Qualifying Office test (the thrust of which is articulated above, although further details are set out in Convention Article 4(1), second sentence) has no counterpart in UCC Articles 8 and 9. However, the Qualifying Office test is not expected to have much effect in practice because intermediaries typically provide that their account agreements will be governed by the law of a country in which they have one or more offices satisfying the test. By virtue of Article 12 of the Convention, which addresses so-called Multi-unit States like the United States, the Qualifying Office test is met for a chosen law of a U.S. state, district, or territory so long as the intermediary has an office in *any* U.S. state, district, or territory. The Qualifying Office test was a product of compromise in the Convention negotiations, worthwhile for the sake of helping to pave the way for eventual ratification by many nations having different legal systems.

#### Filing and Non-U.S. Law Account Agreements

The Convention's accommodation of UCC Article 9's choice-of-law rules for perfection by filing does not cover transactions

in which the intermediary and its customer have contractually chosen non-U.S. law under the Convention's primary rule. Adapting the earlier example, if the New York intermediary and its Texas customer effectively provide that their account agreement is governed by English law (or that English law applies to all of the issues under the Convention), then the Convention will cause the New York forum to look to English law, and not to any rules of UCC Article 9, for all matters of perfection, including whether and how perfection by filing might be available.

#### Filing and Non-U.S. Debtors

The Convention's accommodation of UCC Article 9's choice-of-law rules for perfection by filing also does not cover transactions in which UCC § 9-307 views the debtor to be located in a non-UCC jurisdiction; instead, perfection by filing in those cases will be governed by the law that the intermediary and its customer contractually designate under the Convention's primary rule. Again adapting the earlier example, suppose that the customer of the New York intermediary is an Ontario, Canada corporation with its chief executive office in Toronto, and that the intermediary and customer effectively provide that their account agreement is governed by New York law. In that case, New York's own substantive law (notably NYUCC § 9-501(a)(2) regarding filing with the New York Secretary of State) will govern perfection by filing, and not New York's choice-of-law rules for perfection by filing, which before the Convention would have pointed to a filing under the Ontario Personal Property Security Act. This is because Article 12(2)(b) accommodates UCC Article 9's choice-of-law rules for perfection by filing only if those rules point to a jurisdiction within the United States.

#### Number of Issues Covered

The Convention's package of choice-of-law issues is more comprehensive than the package under the UCC alone. U.S. lawyers have grown accustomed to thinking of perfection, the effect of perfection or nonperfection, and priority as being all

generally determined together, but the law designated under the Convention also pulls in other issues: the requirements applicable to remedies (e.g., foreclosure sales or retention of the collateral), the characterization of a transaction (e.g., as an outright sale or secured loan), and even any effects as against the intermediary or third parties of attachment of a security interest.

#### Certain Transition and Other Practice Tips

Beginning on April 1, the Convention began applying to already-existing transactions, as well as to new transactions going forward, so long as the transaction is one "involving a choice" between two nations' laws, and here as well regardless of whether a non-U.S. nation involved in the choice has also ratified the Convention. In most instances, no further action is necessary to preserve the attachment, perfection, and priority of a security interest.

Clauses designating a U.S. governing law for the account agreement under UCC § 8-110(e)(2) continue to be effective under Convention Article 4(1), provided that the Qualifying Office test is met. Clauses from a pre-Convention account agreement expressly designating a U.S. "securities intermediary's jurisdiction" under UCC § 8-110(e)(1) continue to be effective (because in this context selecting the law to govern *any* of the issues specified in Article 2(1) of the Convention is sufficient), at least if the governing law clause also points to U.S. law, and again provided that the Qualifying Office test is met. In both of these cases, a secured party's perfection by control under the relevant U.S. substantive law continues to be effective. But in a pre-Convention account agreement with a non-U.S. governing law, it is advisable for U.S. lawyers to obtain advice on the effects of the Convention under that body of non-U.S. law. In certain circumstances, such a review might prompt a reconsideration of the appropriate governing law.

Account agreements for new transactions on and after April 1 should not simply rely on the UCC term "securities intermediary's jurisdiction." As noted, the issues governed by the Convention are broader than those



governed by UCC Articles 8 and 9 alone, and accordingly in this context, such a clause would likely not meet the Convention's requirement that the clause cover all of the Convention's issues. Instead of such a clause (and where simply using a governing law clause will not suffice), a two-pronged clause like the following is suggested, especially if the account will include financial assets that are not "securities" as defined in the Convention:

State X [or Nation Y] is the securities intermediary's jurisdiction for purposes of the Uniform Commercial Code, and the law in force in State X [or Nation Y] is applicable to all issues specified in Article 2(1) of the Hague Securities Convention.

A secured party of course should also confirm that the intermediary has a Qualifying Office in the chosen jurisdiction or, if the chosen jurisdiction is a U.S. state, district, or territory, in any other U.S. state, district, or territory.

Where a secured party is relying on perfection by filing, the limitations discussed above on the Convention's accommodation of UCC Article 9's choice-of-law rules for perfection by filing must be borne in mind. As a transition matter in relation to filing, if the account agreement designates a non-U.S. body of law, then it is advisable for U.S. lawyers to obtain advice on perfection and priority under that body of non-U.S. law in order to assess the Convention's effects. And as another transition matter in relation to filing, if the account agreement designates a U.S. body of law, but perfection has been by filing in a non-U.S. jurisdiction, then it is advisable to employ an alternative method of perfection under U.S. law, e.g., filing in the jurisdiction designated by the account agreement.

#### **Further Resources**

This article has necessarily been limited to some of the key issues arising from the

Convention. The Hague Conference on Private International Law has made available the [text of the Convention](#) and the [Explanatory Report](#) referred to above. The Permanent Editorial Board for the Uniform Commercial Code has recently published a [Commentary](#) on the Convention, including amendments to the UCC's relevant Official Comments. The Tri-Bar Opinion Committee is expected to issue a report on related opinion practice to supplement certain prior reports in which choice-of-law rules for the indirect holding system are discussed.

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