

The right way forward

New rules surrounding the choice of law in respect of securities held by intermediaries have been in force since April 1. Some practical issues still need to be ironed out

Given that securities are now commonly held, transferred and pledged by electronic book entry in securities accounts at intermediaries and not through physical possession or other direct holding systems, the need was recognised for a multi-jurisdiction convention on the choice of laws in respect of securities held by intermediaries. The Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, commonly referred to as the Hague Securities Convention (HSC), provides choice of law rules in respect of certain rights relating to those securities and is effective from April 1 2017 in the countries that have adopted it – Switzerland, Mauritius and the US. It is expected to be adopted in due course by all countries with developed commercial systems.

In order to provide legal certainty and predictability in the identification of the governing law for the critical areas of holdings, transfers and security interests in securities held in securities accounts with intermediaries, the HSC establishes uniform choice of law rules. These rules set forth the determination of which substantive law will be applied to these issues. Securities, for purposes of the HSC, means any shares, bonds or other financial instruments or financial assets (other than cash) or any interest therein held with an intermediary in a securities account. The HSC's application is broad – whenever the securities held in a securities account by an intermediary would give rise to a choice between laws of more than one national jurisdiction in relation to the seven legal issues listed below. And it applies whether or not the applicable law (as provided in the Convention) is the law of a country that has adopted it.

Choice of law approaches

The HSC does not provide any substantive law with respect to the transfer or holding of securities or security interests therein – it only provides the choice of law rules for these issues. Historically, the law of the jurisdiction where the securities were located governed the enforceability of transfers of securities and security interests in such property and, for registered securities, such issues were governed by the

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The Hague Securities Convention (HSC) provides uniform choice of law rules when it comes to certain rights relating to securities held as intermediaries. It has been effective since April 1 2017 in the three countries that have adopted it – Switzerland, Mauritius and the US.

The Convention bases its choice of law rules on the governing law specified in the account agreement between the holder of the account and the intermediary, but some exceptions remain. These include if there is no account agreement between the parties, or a governing law not designated in the account agreement or in respect of the issues within the HSC's scope.

The Convention respects the parties' choice of the governing law as reflected in the account agreement, unless they have specified in the account agreement the law of a particular jurisdiction to govern the issues within the scope of the Convention

jurisdiction of the issuer's organisation or of the jurisdiction where the register was maintained. While it worked effectively for direct holdings of securities, that system, when securities are held by intermediaries in securities accounts, would require look-throughs both to the various levels of intermediaries and to the level of the physical certificates, register or issuer. Not only did the HSC reject the look-through approach, it also rejected choice of law based on the location of the account maintained by the relevant intermediary, even though its preamble suggests that the Convention initially considered adopting the latter approach (known as place of the relevant intermediary approach, or *Prima*). That approach has the benefit that the law of one jurisdiction governs all the interests of the investor with respect to its securities notwithstanding that other tiers of intermediaries or the securities, issuer or register would be located in various jurisdictions. The fundamental flaw of that approach is that there exists no global consensus on the precise location of a securities account or the office of an intermediary which maintains a specific securities account.

Primary rule

The HSC bases its choice of law rules on the governing law specified in the account agreement between the holder of the account and the intermediary, subject to a requirement that the intermediary must have, at the time that the account agreement was entered into, a qualifying office in the jurisdiction of the governing law. The Convention thereby respects the parties' choice of the governing law as reflected in the account agreement, unless the parties have further specified in the account agreement the law of a particular jurisdiction to govern the issues within the scope of the Convention (in which case that specified law will govern). Note that when the HSC specifies the law of a jurisdiction, it excludes that

jurisdiction's choice of law rules. But the effectiveness of this choice of law is subject to the qualifying office requirement – at the time the account agreement is entered into, the relevant intermediary must have an office in the respective jurisdiction of the specified governing law, through which office (individually or with another office of the intermediary) the intermediary maintains securities accounts (or handles certain functions for securities accounts) in that jurisdiction. There are some special rules in the Convention for jurisdictions like the US, ie a multi-unit country. One such rule is that this qualifying office requirement can be satisfied if securities are maintained in an account in any state in the jurisdiction even if the governing law is the law of another state in the jurisdiction. Another is that if the choice of law provisions in one state in that jurisdiction designates the law of another state to govern perfection by public filing, the law of that other state governs that issue. This provision preserves the filing rules under the Uniform Commercial Code (UCC) as in effect in the various states in the US when the account agreement is governed by the law of one state (for instance New York) and the account holder is located (for purposes of the UCC) in another state (for instance Delaware). This *internal renvoi* is the only situation in the Convention where internal conflict of law rules are respected.

Given that the governing law specified in the account agreement will generally determine the applicable law for the issues within the scope of the HSC, the Convention has specific provisions to protect the rights of parties if an account agreement is amended to change the applicable law. Article 7 HSC provides that when an account agreement is so amended, the law in effect prior to the amendment continues to govern, among other things, the existence of an interest in securities held with the intermediary arising before the change of law as well as the perfection of a security interest made before the change of law, except with respect to a

person who consents to the change of law. This protective provision will be particularly important to lenders who perfect a security interest in the securities in reliance on the choice of law provisions in the account agreement at the time of perfection.

Fall-back rules

The HSC's primary choice of law rule will not apply if (a) there is no account agreement, (b) a governing law is not designated in the account agreement or in respect of the issues within the HSC's scope or (c) the qualifying office requirement is not met. In these circumstances, the Convention sets forth three further rules to be applied in sequence to determine the applicable choice of law.

Firstly, if the account agreement expressly and unambiguously states that the intermediary entered into the agreement through a particular office and such office satisfies the requirements of a qualifying office, then the law of the jurisdiction of such office shall apply to the issues within the scope of the Convention.

Secondly, if the first fall-back rule has not determined the matter, then the applicable law will be the law of the jurisdiction under which the intermediary is organised at the time the account agreement was entered into (or if there is no account agreement, at the time the securities account was opened).

Finally, if neither the first nor second fall-back rule can apply, then the applicable law will be the law of the jurisdiction in which the intermediary had its place of business (or principal place of business, if more than one) at the time the account agreement was entered into (or if there is no account agreement, at the time the securities account was opened).

Applicable legal issues determined by choice of law

The substantive law as determined by the HSC's choice of law rules applies to seven legal issues in respect of securities held with an intermediary:

- (i) the legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account;
- (ii) the legal nature and effects against the intermediary and third parties of a disposition of securities held with an intermediary;

- (iii) the requirements, if any, for perfection of a disposition of securities held with an intermediary;
- (iv) whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest;
- (v) 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;
- (vi) the requirements, if any, for the realisation of an interest in securities held with an intermediary; and
- (vii) 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.

Disposition means any transfer of title whether outright or by way of security and any grant of a security interest. But it is particularly important to note that the HSC's choice of law rules do not apply to the legal nature of the creation of a security interest against the account holder in the securities held with the intermediary – those issues will be determined between the parties under existing legal principles, but the Convention's application to the rights noted under (i) above will likely guide those preparing security interest documentation in their specification of an appropriate governing law for the creation of a security interest.

Any substantive law issue not included in this list is outside the choice of law rules of the Convention. The issues on this list, however, are both comprehensive and broadly inclusive. Specifically excluded issues include the law applicable to purely contractual or personal rights between the account holder and the intermediary, such as the intermediary's duty of care, or the rights and duties of an issuer, registrar or transfer agent.

Transition rules

The HSC contains several transitional provisions. The first simply provides that a jurisdiction which has adopted the Convention shall apply the law as established by the Convention to determine whether a person's interests in securities held with an intermediary acquired after the date of such adoption has priority over (or terminates) another person's interest in such securities acquired before the

date of such adoption. Given the time-consuming process in any jurisdiction to adopt the HSC, any prudent party should have sufficient time and opportunity to amend its documentation in the unusual circumstances where this may be needed to protect and preserve its interests in respect of this issue.

In addition, these provisions of the HSC seek to permit investors and intermediaries to avoid the cumbersome and expensive process of amending account agreements entered into before the date it becomes effective. As a technical matter, it clarifies that references in the Convention to account agreements and securities accounts include account agreements entered into, and securities accounts opened, before its effective date. Also, it includes two interpretive rules applicable to account agreements entered into before a jurisdiction adopted the HSC unless the account agreement contains a specific reference to the Convention (in which case the choice of law rules of the Convention apply).

Those interpretive rules are intended to respect certain choice of law provisions of pre-

election is consistent with the parties' intent). Without such election, the governing law of the account agreement will establish the choice of law for such issues.

Final comments

Where securities are held through a long chain of intermediaries (clearing systems, depositaries, custodians and so on), it is very likely that some intermediaries are in different jurisdictions and hold their custody-type interests under agreements having different governing laws. The Convention will result in the laws governing the in-scope issues being separately determined at each level of the chain. Those issues at different levels are therefore likely to be governed by different substantive rules.

When the UK chooses to adopt the HSC, it will likely need to make some adjustments to existing legislation. The Financial Collateral Arrangements (No 2) Regulations 2003 currently follow the *Prima* approach and

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Convention account agreements on the presumption that the parties intended that law to apply to the issues within the scope of the Convention. When an existing account agreement provides for a governing law for certain of the issues within the scope of the HSC, that law will apply to all such issues (subject to complying with the qualifying office requirement). Also, when an existing account agreement specifies the location of the securities account, the law of that jurisdiction will govern all such issues (subject to complying with the qualifying office requirement). Finally, there may be account agreements which both specify one jurisdiction as the location of the securities account and another jurisdiction as the governing law. The HSC permits a jurisdiction which adopts the Convention in effect to elect that the jurisdiction where the securities account is maintained will be the governing law for all issues within the scope of the Convention (on the assumption that such

adopt the domestic law of the country in which the securities account is maintained to govern a number of these issues.

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