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Securities Alert

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Lending Against Securities After April 1, 2017

The Hague Securities Convention, which goes into effect in the United States on April 1, 2017, will have significant impact on the law applied to all transactions - - past and future - - collateralized by securities held by an intermediary (e.g. a brokerage firm, bank trust department, etc.), where there is any international aspect to the security, such as the nationality of the security issuer, security holder, intermediary, party to the security transfer, adverse claimant, or the location of the security certificates.

To ensure that their intended choice-of-law is applied, every lender (bank or otherwise) who lends money for which securities are collateral, and every borrower who borrows money secured by collateral in the form of securities, should make sure that the following text is included in the *account agreement* between the securities' owner and intermediary, whenever the securities are held by an intermediary:

> The State [for these purposes a state of the United States] of _____ is the securities intermediary's jurisdiction for purposes of the Uniform Commercial Code of _____, and the law in force in the State of _____ is applicable to all issues specified in Article 2(1) of the Hague Securities Convention.

Where, however, the lender or borrower wishes to designate a different state's laws for issues arising under the account agreement other than with respect to the securities held with the intermediary, then for those securities the account agreement should instead provide:

> The law applicable to all issues specified in Article 2(1) of the Hague Securities Convention is the law in force in the state of _____.

In addition to including these provisions in any account agreement entered into after the April 1, 2017 effective date, existing account agreements should be amended as soon as possible to include either the general governing law provision (first set out above) or the more limited Article 2(1) governing law provision.

What do these provisions accomplish?

The cited provisions are choice-of-law provisions that select the governing law for the intermediary account agreement, which under the Hague Securities Convention will then also dictate the governing law for other issues regarding the securities, enumerated in Article 2(1) of the Convention, such as perfection of liens and priority of interests. By designating the governing law with reference to the Hague Securities Convention, the provisions eliminate ambiguity (and potential conflicts) over which jurisdiction's laws apply when determining: (i) whether a lien has been perfected; (ii) what kind of foreclosure processes are required; and (iii) how an adverse party can challenge the situation – all those are answerable by reference to the chosen governing law. Note, however, they do NOT change the substantive law of that chosen law; neither the provisions nor the Hague Securities Convention change anything with respect to any regulatory requirements applicable to an intermediary or any other party.

The Hague Securities Convention is intended to resolve uncertainties in determining which countries' laws should be applied which had developed as secured transactions evolved and grew more complex. Historically, it was possible to obtain a lien (called a security interest under the Uniform Commercial Code ["UCC"]) on a security by taking physical possession of the security. With the growth of book-entry securities (such as U.S. Treasuries and Agencies) and greatly increased administrative burdens involved, the commercial world evolved by the mid-1990's to recognize the role of securities intermediaries -- typically trust companies, brokerage firms, and specialized third-party players such as the Depository Trust Company and Euroclear. This evolution was recognized in U.S. law by the amendments to Articles 8 and 9 of the UCC, which specifically recognized securities intermediaries and prescribed how a lender might perfect a security interest in an account of a securities holder at a securities intermediary. However, these UCC revisions did not address what law governs when the situation involves an international aspect when any of the following are located in a different nation:

- The account holder
- The issuer of the securities
- Any party to the transfer of the securities
- Any securities intermediary
- The physical location of the securities certificates
- Any adverse claimant

For example, if a New Jersey resident owned securities of a foreign issuer (e.g., Unilever, Novartis, Alibaba, etc.) and wished to use those securities as collateral for a loan made by a Pennsylvania bank, what law would govern questions of perfection, etc.? What if the lender were a Spanish Bank?

In 2000, the Hague Conference on Private International Law began work on a treaty to address these issues. The resulting Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary ("the Hague Securities Convention") was promulgated in 2006. Two nations, Switzerland and Mauritius, promptly ratified the Convention. The United States signed it in 2006, but did not submit it to the U.S. Senate for its advice and consent until 2012, and that advice and consent was not given until September 2016. The U.S. submitted its instrument of ratification to the Hague in December 2016. The Convention provides that it becomes effective 90 days after three nations have ratified it, so with the U.S. ratification, the Convention becomes effective on April 1, 2017. Although only three nations are now bound by the Convention, it is expected that the Convention will soon be ratified by other major capital market countries such as Japan, the UK, Germany, Australia, and the like, especially with the U.S. having ratified the Convention and the size of the U.S. securities markets. In addition, it is expected that provisions in an account agreement specifically invoking the Hague Securities Convention will be given considerable deference by the courts even in non-signatory nations.

What is required to be a governing law?

Two things are required. First, the choice should be expressly made. If an express choice is not made, there are a series of fallback rules under the Convention, but clearly the far better approach is to make an express choice.

Second, the jurisdiction whose law is chosen must be a jurisdiction (i.e. nation) where the intermediary has a "Qualifying Office." A "Qualifying Office" is an office that is engaged in the regular

activity of maintaining securities accounts. Nations like the United States (with our fifty States) or Canada (with its ten Provinces and three Territories) are termed "Multi-unit States." The intermediary can have a Qualifying Office in *any* of the units of a Multi-unit State, even if the "unit" whose law is chosen is not the same unit where the Qualifying Office is located. So, for example, an account agreement with an intermediary physically located in the State of Massachusetts could validly select the law of the State of New York as governing law, even if it has no office in New York. It is expected that many intermediaries regularly dealing in securities will adopt New York law because of the long-standing and voluminous securities transactions in that jurisdiction. New York law might be the governing law selected even for account agreements with account holders and/or intermediaries located far outside of New York - - in Idaho, Arkansas, Illinois, or Alabama; the selection of New York law will be valid so long as the intermediary has a Qualifying Office anywhere in the United States, and there is some international element to the securities or transaction.

What effect does the Hague Securities Convention have on perfection by filing?

The Convention does not affect perfection of a lien by taking physical possession of the securities. However, the Convention may affect perfection of a lien by filing, including the place where the security interest or other lien implementation document must be filed. Under the relevant provision of the UCC (§ 9-305) the jurisdiction of the intermediary, NOT the borrower determines the effect of perfection and the priority of the security interest (a lien). Under the Hague Convention, in a Multi-unit State such as the United States, where the governing law of the jurisdiction chosen in the account agreement requires that the law of a different location governs perfection by public filing, the law of that other location will apply, so long as it is another territorial unit of the same Multi-unit State. (Hague Securities Convention, Art. 12(2)(b). The question of where to file is one that must be carefully considered in each case. A few examples may assist in clarifying this point:

Example 1: A borrower located in New Jersey offers its stock in Unilever, a Dutch company, to secure a loan. Its securities account is with an intermediary located in New York, and the account agreement specifies that New York law governs. Under the New York UCC, the lender taking an interest in the securities held by an intermediary under an account agreement as collateral must file in the borrowers' location to perfect its lien. (UCC §§ 9-301 and 9-307). Thus, the lien should be filed in New Jersey. Under the Hague Convention, the same result is reached; New York law applies based on the choice-of-law provision in the account agreement, which is enforced because the intermediary has a Qualifying Office in the United States. New York law dictates filing in New Jersey, which is another "territorial unit" of the same "Multi-unit State" (i.e. the United States).

Example 2: A same facts as Example 1, except the borrower is organized under German law. German law does not generally require a filing for protection. Under the UCC (§§9-301 and 9-307(c)), if there is no appropriate place to file outside the U.S. to perfect a security interest, the default rule is to file in the District of Columbia. Thus under the UCC, the filing should be made in the District of Columbia. Under the Convention, New York law governs pursuant to the intermediary account agreement, and because the District of Columbia is another territorial unit of the same Multi-unit State (i.e. the United States), the filing in the District of Columbia is effective.

Example 3: Same facts as Example 2, except now the borrower is an Ontario, Canada corporation with its main office in Toronto. Canada (unlike Germany in the prior example), has a well-recognized filing system, so under the UCC (§ 9-305) a lender would typically file in Ontario. Here, however, the outcome is

different under the Hague Convention. New York law was chosen to govern in the intermediary account agreement, and Ontario is NOT a unit of the same Multi-unit State (i.e. the United States) as New York. Accordingly, the filing of the security interest must be made with the Secretary of the State of New York.

Important Take-Away

Review the choice of law provision in every account agreement with intermediaries and make certain: (i) that after April 1, 2017, the text invokes the Hague Securities Convention as set out above AND (ii) that the intermediary has a Qualifying Office in the United States.

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