

A transactional approach to the Hague Securities Convention

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Key points

- Transactions involving intermediated securities – ie securities that are held in an account with a broker, bank, clearing agency or other intermediary – demand a high degree of *ex ante* legal certainty. However, for intermediated securities accounts and transactions that reach across borders as is increasingly prevalent, the traditional conflicts of law rules for many of the most important commercial law issues fail to provide this certainty.
- The Hague Securities Convention provides a modern and practical approach for determining the applicable law. In most cases, the express terms of the agreement between the applicable account holder and its intermediary will be determinative, including as against third parties, provided that at the time of the agreement the intermediary is engaged in the business of maintaining securities accounts in the specified jurisdiction. The Convention is expected to be ratified in some nations fairly soon.
- Once the Convention becomes effective, it can affect even transactions that are already in place. Transactional lawyers should accordingly begin to draft today's account agreements with the Convention's effects in mind.
- An account agreement will fully take advantage of the Convention's benefits if it expressly includes either a general governing law clause or what this article calls a Hague issues clause, subject again to the proviso about the intermediary's business in the selected jurisdiction.
- It should generally be unnecessary to amend past transactions, because the Convention contains well-conceived interpretive rules applicable to them.

The Hague Securities Convention, formally known as the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, is expected to be ratified in some nations fairly soon, and once the Convention becomes effective it can affect even transactions that are already in place. Accordingly, the Convention should now be playing a distinct part in the analysis and drafting that lawyers undertake with respect to all of their intermediated securities transactions.

The Convention's purpose is to provide clear and practical conflict of laws rules for the most important commercial law issues affecting intermediated securities, ie securities that are credited to an account with a broker, bank, clearing agency or other

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intermediary. Its thrust is that the applicable law may be determined by an express provision of the account agreement between the account holder and the intermediary if, at the time of the agreement, the intermediary is engaged in the business of maintaining securities accounts in the specified jurisdiction. Under the Convention, the law that is determined in this manner will be effective even against persons that are not party to the account agreement.

As a result, the Convention can be expected to bring powerful benefits both to private actors and to markets as a whole. First, account holders, intermediaries, lenders and other private actors should benefit on an *ex ante* basis from the ability to foresee exactly which law will govern even complex transactions involving elements from multiple jurisdictions. The persistent analytical uncertainties and heavy diligence costs that have burdened such transactions in the past will be alleviated, and as a result, transactions that are desirable to the parties should be more likely to go forward on a more economical basis. With just a sentence or two of good drafting and a few easily focussed factual inquiries, transactional lawyers will be able to provide their clients with the protection of advantageous bodies of substantive law, reliably applied in any eventual forum of a State that is party to the Convention. And this substantive law will apply broadly, to a powerful range of commercial law issues that might arise under various eventualities flowing from the transaction. For example, a single, foreseeable body of law will govern the intermediary's duties to the account holder and third parties resulting from any credit of securities to the account. The same will also be true of a range of issues affecting secured lenders, repo counterparties or others in whose favour dispositions of securities credited to the account are made. And in all of these cases the same law will apply without regard to the nationality or other attributes of the issuers of the various securities, so that entire portfolios of existing credits, and even future streams of after-acquired credits, can be dealt with in a single analysis.

Related benefits should extend beyond the transactions' immediate participants, to the economy as a whole in the form of enhanced market stability and liquidity. Financial institutions, regulators and ordinary market participants will be able to draw confidence from the increased transparency of a participant's legal rights, even in times of market stress. For example, the Convention would directly and significantly contribute to a bank's ability to use securities collateral as a credit risk mitigation technique, for purposes of the minimum regulatory capital requirements in the first pillar of the Basel II accord.¹

This article examines the nature and impact of the Convention's legal and practical core. Space limitations preclude a comprehensive treatment of the entire Convention, or even of all of the ramifications of its chief provisions. Instead, the article closely analyses

1 See Bank for International Settlements, Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework paras 118 (requiring a 'well founded legal basis' that collateral documents are binding and enforceable 'in all relevant jurisdictions'), 123 (requiring the bank to, among other things, take relevant steps for enforceability that are necessary 'under the law applicable to the bank's interest in the collateral') (2004). See generally P Dupont, *Regulatory Aspects of the draft Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary*, <<http://www.imf.org/external/np/leg/sem/2002/cdmfi/eng/dupont.pdf>> (2002).

the Convention's chief mechanism, which is its enabling of an agreement-based designation of the applicable body of commercial law, together with the scope, definitional and other Convention provisions that are most important for understanding the full meaning and effect of the agreement mechanism. In the authors' view, the Convention's chief importance is to transactional lawyers (though it also benefits the litigation process if a dispute should later arise), and in keeping with that view this article adopts a transactional focus as well. It highlights the advantages that the Convention makes available to transactional lawyers through good drafting and foresight. As US lawyers, the authors have naturally drawn a number of their examples discussed here from US law and practice, but the article's analytical framework is designed to be equally helpful to those in other jurisdictions worldwide.

Section 1 of this article provides a brief introduction to the Convention in the context of evolving market forces. Section 2 explains the Convention's core agreement-based mechanism in detail. The first part of section 2 explains the issues as to which the Convention enables account holders and intermediaries to provide the applicable law, and explores certain important related definitions, as well as what might loosely be called the Convention's internationality requirement. The second part of section 2 then looks carefully at two chief ways in which the parties may cast their agreement on these issues so as to achieve the Convention's effect. And the third part of section 2 analyses a modest limitation on the agreement mechanism, which prevents the agreement achieving the Convention's effect unless the intermediary has certain connections to the applicable jurisdiction. Section 3 turns to the Convention's beneficial effect even on agreements that do not employ the Convention's core agreement-based mechanism to the fullest, whether because of an omission by the parties or simply because the account agreement was finalized prior to the Convention. As suggested before, already-existing transactions are generally within the Convention's scope, and this part of the article explains how they will be affected and what, if anything, should be done in connection with those transactions now.

1. The Convention as a response to evolving markets

In recent decades, ownership of most securities has evolved dramatically in the direction of intermediation. In an intermediated system, securities are held in book-entry accounts that are maintained by at least one broker, bank, central securities depository or other intermediary that is situated between the issuer of the securities and the account holder. Transactions in these assets are effectuated by means of debits and credits to the accounts, and often settled through chains of intermediaries that are unknown or even unknowable to the immediate parties. Depending on applicable national substantive law, credits to an account may or may not give the account holder rights directly against the issuer, but this variable is irrelevant to the nature of intermediation itself, and to the commercial law issues for which the Convention determines the conflict of laws rules.

The prevalence of intermediation, particularly in an advanced technological environment, permits parties to carry out transactions much more rapidly and in much greater volume than ever before, and institutions are able to process and settle those transactions with vastly greater efficiency. As these larger volumes of available capital seek out their best opportunities, it has become routine for transactions to reach across international borders, not only as between the immediate parties to a sale, secured loan, repo or other transaction, but even more so when one takes into account the intermediaries, issuers or others involved in the transaction.

Concomitantly, questions of conflict of laws in the intermediated securities context have become impossible to ignore. With the variety of widely dispersed parties that can be involved even in simple transactions—account holder, broker or other intermediary, higher-tier intermediaries and clearing agencies, issuers, not to mention one or more secured parties or others in whose favour dispositions might be made and their competing creditors—it is vital to understand which bodies of substantive law govern which issues, and in which relationships. The stakes are all the higher in light of the large substantive differences among various national commercial law systems, the value of the assets that can be at stake in a given transaction let alone systemically, the high associated time pressures, and the range of forums in which an eventual dispute might arise.

At the same time as they have grown in importance, the conflicts questions have also grown in difficulty. The traditional approach to resolving conflict of laws questions about the commercial law of securities has been to apply the *lex rei sitae*, or law of the place in which the things are located. In earlier times, this may overall have been a sensible enough approach, whether as applied to the location of the security certificates, or of the registry of security holders, or of the issuer's principal place of business or place of central administration or jurisdiction of organization. But as applied to intermediated securities, the *lex rei sitae* approach is impractical, because the locations of most of the things to which it looks are fortuitous, and often unknown to (or even unknowable by) the parties. Under a *lex rei sitae* approach, especially as divergently applied in different jurisdictions in the absence of harmonization, a dispute over an intermediated securities transaction can be a litigator's feast. But for a transactional lawyer seeking to advise a client *ex ante* about the degree of risk involved in making a new loan against an international portfolio, let alone advise a money centre bank about the degree of risk in joining a governmentally encouraged bailout of a major hedge fund, the conflicts problems are baffling and ultimately unresolvable.

The Hague Securities Convention provides a fresh approach to these problems, consciously designed to fit the realities of modern intermediated securities systems. The Convention's central rule provides simply that the conflicts issues are governed by the law that is expressly agreed in an account agreement between the account holder and its immediate intermediary.² It explicitly rejects the *lex rei sitae* rules, not only by refusing to

2 Convention Art. 4. Unless otherwise noted, citations herein are to the Convention, the full text of which is available at the web site of the Hague Conference on Private International Law, <<http://hcch.e-vision.nl>>.

'look through' the securities account at one or another of the traditional criteria described before,³ but also by declining to achieve an artificial certainty by assigning a location to the account itself.⁴ The Convention looks at, rather than through, the securities account, and derives its certainty directly from the terms of the account agreement.

The text of the Convention was adopted by the Hague Conference on Private International Law in late 2002, and its final text was released in early 2003.⁵ By its terms, the Convention enters into force following ratification by three nations.⁶ In mid-2006, the United States and Switzerland both signed the Convention at the same time, as a means of signalling an important level of joint support from two countries having leading banking and securities industries. Preliminary efforts to move the Convention through the executive branch of the US government en route to the Senate ratification process are under way at the time of this writing, as are definite steps in the Swiss legislature. Elsewhere, the Convention's future in Europe remains unresolved, though the European Commission has concluded that adoption of the Convention would be 'in the best interest of the Community',⁷ and there is optimism about the prospects for favourable action in other nations.

2. Certainty as to applicable law as the result of express agreement

At its core, the Convention provides a mechanism by which an express agreement between the account holder and its intermediary can determine the law that will apply to a broad range of commercial law issues affecting intermediated securities, provided that the intermediary meets a qualifying office requirement in the State whose law is so specified. The Convention's goal is certainty as to applicable law, and it looks to the terms of the express agreement as a means to this end. As discussed subsequently, the Convention does not affect matters of freedom of contract *per se*. But to the extent that the express agreement is effective, the Convention provides the agreement with conflict of laws effects that it would not otherwise have, and in that sense the Convention enhances the power of the drafter's pen.

Scope of the law chosen: issues, definitions and internationality

The Convention's Article 2(1) describes the substantive issues for which the Convention prescribes the applicable law; Article 1 provides important definitions that clarify the

3 Article 6.

4 Compare, eg Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements [2002] OJ L 168/43, Art. 9 (certain matters concerning book-entry securities collateral are governed by 'the law of the country in which the relevant account is maintained').

5 Helpful sources on the Convention that have been published since then include R Goode, H Kanda and K Kreuzer, with the assistance of C Bernasconi (Permanent Bureau), *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* (2005); JS Rogers, 'Conflict of Laws for Transactions in Securities Held Through Intermediaries' (2007) 39 Cornell Int'l LJ 285; C Bernasconi and HC Sigman, 'The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (Hague Securities Convention)' (2005) 10 Uniform L Rev 117.

6 Article 19.

7 Commission of the European Communities, Legal assessment of certain aspects of the Hague Securities Convention, SEC(2006) 910 (3 July 2006).

breadth of and limitations on those issues; and Article 3 provides the Convention's applicability to a choice between laws of different States.

Among its important issues, the Convention law will determine the effects against the intermediary and third parties of a 'disposition' of securities held with an intermediary.⁸ A disposition is defined as 'any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory'.⁹ This concept is intended to cover the gamut of consensual transfers by an account holder, including but not limited to sales, transfers as collateral security, repo agreements, securities lending arrangements and contributions to capital. Depending on applicable substantive law, and on prevailing practice or the parties' preferences, an outright transfer may or may not be accompanied by a debiting of the transferor's account and a crediting of the transferee's; a grant of a security interest may or may not be, as well; but all of these permutations are nonetheless dispositions within the meaning of the Convention. Moreover, the definition of 'disposition' is intended to be inclusive, and to dispense with rather than heighten questions about the characterization of transactions. Thus, for example, lingering questions about the legal nature of repurchase agreements, which are sometimes thought to fall in a grey zone between outright transfers and security interests, do not create doubts about the Convention's applicability.¹⁰ Also, dispositions by an account holder in favour of its intermediary are explicitly covered,¹¹ in order to avoid doubts based on the idea in some systems that the intermediary already 'has' the securities. The overall result is to provide certainty about the coverage of consensual transactions both innovative and routine.¹²

Among the particular disposition-related matters that the Convention covers are the requirements, if any, for perfection of the disposition;¹³ the requirements, if any, for the realization of an interest in securities held with an intermediary;¹⁴ whether the disposition extends to entitlements to distributions or proceeds such as dividends, redemption payments or amounts received upon sale;¹⁵ whether a party is subordinate to, has priority over, or takes free of the interest of another party;¹⁶ and more generally,

8 Article 2(1)(b).

9 Article 1(1)(h). In legal systems that address intermediated securities on their own terms, the definition's reference to 'possessory' transfers of title and security interests may seem puzzling, but it is included in order to ensure coverage of legal systems that assimilate intermediated holdings to physical holdings of chattels.

10 The same may be said about dispositions for value versus dispositions in favour of a donee, where the line may also sometimes be blurred, and where the Convention also imposes no need for the inquiry.

11 Article 1(2)(b).

12 The concept of disposition also includes one common situation that, though often arising in connection with consensual transactions, is not necessarily itself fully consensual. This is 'a lien by operation of law in favor of the account holder's intermediary in respect of any claim arising in connection with the maintenance and operation of a securities account'. Article 1(2)(c). Examples under US law would be the security interest that attaches automatically on an asset-by-asset basis under UCC s 9-206(a) and (b), as well as the older and potentially broader common-law broker's liens.

13 Article 2(1)(c). Perfection is defined in Art. 1(1)(i) by reference to effectiveness of a disposition against persons who are not parties to the disposition, and as a result, the term may apply to dispositions that are not secured transactions, just as under US law there are perfection requirements for the outright sale of certain receivables.

14 Article 2(1)(f).

15 Article 2(1)(g).

16 Article 2(1)(d).

the legal nature of the disposition,¹⁷ whether as against the intermediary or third parties. This reference to 'legal nature' includes characterization questions, so that if a repurchase transaction involving elements of both Nation A and Nation B were the subject of a sale versus secured loan dispute, the Convention would determine which nation's law applied to the question. None of these issues affects the rights of an account holder or of anyone else as against the issuer.

Quite apart from dispositions, the Convention also applies generally to the rights of the account holder, whether as against the intermediary or third parties, that result from the credit of securities to a securities account. This includes the issues of whether the intermediary has duties to a person other than the account holder who claims a conflicting interest;¹⁸ whether the account holder is subordinate to, has priority over, or takes free of the interest of another party;¹⁹ and the legal nature and effects of the credit.²⁰ This reference to 'legal nature' includes the question, mentioned earlier, of whether a credit to a securities account confers rights that are enforceable directly against the issuer or only against the intermediary, as well as whether the rights resulting from a credit are proprietary or contractual in nature or a hybrid of the two, as in the United States.²¹ Where a credit has factors connected with more than one nation, the Convention will determine which body of substantive law applies to this question (and the contrary idea, according to which the Convention would only apply if the result of a credit were something more than contractual, is explicitly and correctly rejected).²² But here, too, the Convention does not determine the law applicable to the rights and duties of the issuer, whether in relation to the account holder or anyone else.²³

Credits to a securities account or dispositions of securities held with an intermediary can also present conflict of laws questions about numerous purely contractual rights and duties that do not fall within the Article 2(1) issues. Examples involving a credit include the law governing the enforceability of the account agreement's arbitration clause, or of its specification of fees, or the content of the intermediary's standard of care in maintaining the assets credited to the account. Examples involving a disposition include the law governing matters such as the number and type of securities agreed to be sold, their price, the consequences of a party's failure to make payment as agreed or the debtor's failure to adhere to covenants in a security agreement. The Convention has no effect on these conflicts questions.

The definition of 'securities held with an intermediary' is a linchpin of the Convention's scope, because it limits the Convention's applicability to all of the issues

17 Article 2(1)(b).

18 Article 2(1)(e).

19 Article 2(1)(d).

20 Article 2(1)(a).

21 See UCC Art. 8, Part 5.

22 Article 2(2).

23 Article 2(3)(c).

just described.²⁴ The term is defined as ‘the rights of an account holder resulting from a credit of securities to a securities account’,²⁵ and it should be stressed that the Convention, in contrast to some national conflicts rules, accordingly does not apply in the absence of a credit.

Nested within this definition are two other terms, ‘securities’ and ‘financial asset’. The term securities is defined broadly in order to accommodate future market developments, and the definition is neutrally drafted so as to embrace all of the varying substantive regimes, whether or not a credit confers rights directly against the issuer.²⁶ The Convention does not involve any requirement that the securities be listed or eligible for listing on an exchange, or that the intermediary hold the securities directly or indirectly through a higher-tier intermediary (a common situation that the Convention is deliberately designed to accommodate), or indeed at all. The concept of securities expressly includes all financial assets other than cash, but the term financial asset is not itself defined, and US lawyers are cautioned against assuming that UCC Article 8’s broad and carefully structured meaning of the term would necessarily apply under the Convention.²⁷ The exclusion of cash has the effect of leaving conflicts rules for cash balances carried in securities accounts to other law, but this, like the fuzziness at the edges of other aspects of ‘securities held with an intermediary’, is only a modest limitation to the certainty that the Convention brings to transactional lawyers.

Also important to the Convention’s scope is Article 3, which provides simply that the Convention applies ‘in all cases involving a choice between the laws of different States’.²⁸ Whether a transaction ‘involv[es] a choice’ is an open-ended question that is consciously designed to be independent of any concrete list of ‘connecting factors’ as under some other international instruments. The practical result is that a careful transactional lawyer should almost always take the Convention into account, in addition to applicable non-Convention law.²⁹ This is true even for transactions in which all of the seemingly salient elements (for example, the account holder, intermediary, issuer, third parties in whose favour dispositions are made and the relevant agreements’ governing law clauses) point to one jurisdiction: after all, an eventual decision maker in an eventual dispute might decide that an otherwise peripheral or un contemplated element of the transaction makes the transaction ‘involv[e] a choice’. More important, even a transaction that all would

24 ‘This Convention determines the law applicable to the following issues *in respect of securities held with an intermediary*.’ Article 2(1) (emphasis added).

25 Article 1(1)(f).

26 Article 1(1)(a) (‘“securities” means any shares, bonds, or other financial instruments or financial assets (other than cash), or any interest therein’) (emphasis added).

27 UCC s 8-102(a)(9).

28 The reference to ‘all cases’ means ‘all situations’ and should not be misunderstood as limiting the Convention to a litigation context.

29 Double-planning so as to accommodate non-Convention conflicts law should be important only to the extent that either the transaction is heavily enough localized that a judge might find there to be no ‘choice’, or, of course, litigation is otherwise foreseeable in a forum that would apply non-Convention law.

The fact that elements are involved from two or more different territorial units of a single Multi-unit State does not, of itself, lead to the conclusion that the transaction involves a ‘choice between the laws of different States’, because the term State generally refers to nations as a whole rather than to their territorial units, and Art. 12(1)’s refinements to that term do not apply to Art. 3.

agree is thoroughly domestic at its outset can later come to genuinely require a choice because of the involvement of a new party from a different jurisdiction, such as an adverse claimant to the securities credited to the account. The Convention is, then, potentially controlling even for transactions that may seem purely domestic at certain points to certain observers, and this enhances the Convention's reliability for those who plan their transactions with it in mind.

Express agreement in either of two forms

The account holder/intermediary agreement will determine the applicable law for the Article 2(1) issues if the agreement takes either of two forms: a general governing law clause or what will here be called a 'Hague issues clause'.

General governing law clauses appear in many account agreements and other transactional documents of all kinds, and readers of this article are presumed to be familiar with them. What is new about them here is that the Convention expressly gives them an effect that reaches beyond their traditionally strictly contractual scope, to include the broad range of Article 2(1) issues described above, even as against persons that are not party to the account agreement. Because these clauses are already such standard tools, the Convention will have the effect of bringing certainty on conflicts matters to almost all securities accounts that are opened after the Convention's effectiveness. Accordingly, drafters will need to be aware of the new layer of effects that the old tools will have.³⁰

In some transactions, drafters may want to continue to use general governing law clauses only for their traditional purpose, and not for their new Convention purpose. For example, an account holder and intermediary may want the Article 2(1) issues to be governed by the highly developed and transparent law of Nation A for the sake of a future contemplated capital markets transaction, while also wanting purely contractual matters *inter se* to be governed by the familiar local law of Nation B. Both of these desires can be accommodated by means of a Hague issues clause, which is simply a clause specifying that the law of a particular State governs all of the issues specified in Convention Article 2(1). If the account agreement contains both a general governing law clause and a Hague issues clause, then the latter generally controls.³¹ The result is flexibility for transactional lawyers, who can increase the economic benefits to various parties by allocating different legal benefits and burdens in accordance with the players' needs.

The Convention does not, however, allow this unbundling of conflicts issues to go any further. A Hague issues clause is effective only if it designates a single State's law for *all* of the Article 2(1) issues. The singling out of particular Article 2(1) issues for *à la carte* treatment is ineffective, and an agreement's attempt to do so would simply lead to application either of the general governing law clause or of alternatives even less likely to

³⁰ On a related subject, see the discussion of pre-Convention account agreements in section 3.

³¹ This general point may, however, be affected by the Qualifying Office requirement discussed below. Similarly, if the account agreement contains only one clause or the other, and the Qualifying Office requirement is not satisfied with respect to that clause, then the core mechanism of the Convention has not been successfully used, and certain fall-back rules will supply the applicable law, just as if the agreement contained neither clause. See section 3 below.

have been desired.³² And of course a general governing law clause, when used by drafters for Convention purposes, similarly leads to the application of a single State's law for all of the Article 2(1) issues. Both of these outcomes balance an interest in permitting flexible structuring of transactions against the prevention of potentially disruptive contractual practices.

The Convention requires that the general governing law clause or the Hague issues clause, as applicable, be specified 'expressly'.³³ This does not mean that any particular magic words are required,³⁴ and each law firm will develop its preferred formulation of a Hague issues clause (just as it doubtless has done for a general governing law clause).³⁵ But the contents of the applicable clause do need to be expressed directly by whatever words are used, rather than being left to implication. In these clauses that carry out the Convention's core purposes, the goal of *ex ante* certainty demands clarity of drafting, and unstated intents must be disregarded even if they are real and might eventually have been discovered through a judicial search.

Because securities holdings can often involve more than one tier of intermediary, and therefore more than one account agreement, the Convention makes clear that the applicable account agreement is the one between the account holder in question and the 'relevant' intermediary, ie the account holder's own intermediary rather than any other intermediary at a higher or lower tier.³⁶ For example, in a situation where an account holder holds through a broker, which in turn holds through a clearing agency, the relevant account agreement for determining the account holder's rights is the one between the account holder and the broker, not the one between the broker and the clearing agency.³⁷ This is consistent with the Convention's overall rejection of the various forms of a

32 See discussion of the fall-back rules in section 3. US lawyers should note that the UCC Art. 8 practice of contractually specifying the 'securities intermediary's jurisdiction' under s 8-110(e)(1), without more, would not appear to pick up all of the Convention's Art. 2(1) issues and accordingly may not constitute an effective Hague issues clause. Pre-Convention agreements, however, do not face this difficulty, as discussed in section 3.

33 Article 4(1).

34 For example, the Convention need not be expressly referred to in either clause, though as a practical matter most Hague issues clauses should have an express reference to the Convention's Art. 2(1) simply in the interest of clarity of drafting. Also, in pre-Convention account agreements it may in some cases be desirable to refer expressly to the Convention at a given point in the agreement as discussed in section 3.

The Convention does not impose a writing requirement, but naturally the account agreement should generally be in writing or its equivalent, in the interest of certainty.

35 One good example of a Hague issues clause specifying New York law is: 'The parties hereto agree that the law applicable to all issues in Article 2(1) of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary is the law in force in the State of New York.'

36 Articles 1(1)(g), 6(d).

37 This is subject to an exception when an account holder makes a disposition in favour of its own intermediary, I-1, for example to secure a margin loan. Depending on applicable law and practice, the credit to I-1 might be reflected either in an 'own funds' account on I-1's own books, or by a transfer from I-1's customer account to I-1's proprietary account on the books of I-2, a higher-tier intermediary through which I-1 holds. The Convention does not permit this technical difference to affect the applicable law; even in the latter case, the relevant intermediary is I-1, not I-2, and the law governing I-1's rights is determined by the account agreement between I-1 and the account holder, not the one between I-1 and I-2. Article 4(3)(a), (b). See also Art. 1(2)(b) (making clear that dispositions in favour of an account holder's intermediary are otherwise covered in the same way as other dispositions).

'look-through' approach. It also has the result that, in a transaction involving more than one intermediary, the rights of different parties will often be governed by different law.³⁸

Although the Convention's core mechanism generally validates agreements that designate the law of a 'State', and that term is understood as referring to nations as a whole, the Convention also makes sensible provision for account agreements that designate the law of a territorial unit of a Multi-unit State. For example, if an account agreement designates the law of New York, then the Convention applies the law in force in New York, which includes not only the law promulgated by New York authorities themselves but also, to the extent applicable in New York, the law of the United States itself.³⁹

As a further important benefit to transactional practice, the Convention eliminates renvoi, and thereby frees lawyers from the investigation of many obscure, uncoded or otherwise difficult legal questions. Accordingly, an account agreement that specifies the law of Nation A will lead to the application of Nation A's own substantive law, rather than the substantive law of whatever jurisdiction Nation A's non-Convention conflict of laws rules might designate.⁴⁰

The Convention is generally applicable, meaning that the Convention law applies whenever the forum adheres to the Convention, regardless of whether the law to which the Convention points is itself that of a Contracting State.

The Qualifying Office requirement

Neither the general governing law clause nor the Hague issues clause will effectively determine the law applicable to the Article 2(1) issues unless the so-called Qualifying Office requirement is also satisfied. The Qualifying Office requirement provides that the relevant intermediary, at the time of the agreement, must have an office that is 'engaged in a . . . regular activity of maintaining securities accounts', or that is identified by specific means as doing so, located in the State whose law is designated by the account agreement's clause in question.⁴¹ This requirement does not by any means purport to determine a genuine or a deemed 'location' for the securities account, nor do any of the Convention's rules depend on such a location, even if one could be specified. Instead, the Qualifying Office requirement simply provides a limitation, based on the intermediary's

38 For a discussion of this complex situation, sometimes called the 'page 37 problem' because of its place in the document that gave rise to the discussions during negotiations, see *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, at paras 4–43 and following; Rogers, above, at 318–327.

39 Articles 4(1), 12(1)(a), 12(2)(b) and 1(1)(m). As a result, in this example, the Convention would bring in not only New York's UCC or other substantive commercial law provisions but also, to the extent they apply to the particular facts, the TRADES regulations governing book-entry Treasury securities and the customer-protection rules promulgated under the Securities Exchange Act of 1934.

40 Article 10. In a limited context, the Convention preserves the internal conflict of laws rules within a Multi-unit State as to filing, recording or registration. Article 12(2)(b). For example, if the account agreement designates New York law, and the account holder which is organized under the law of Delaware grants a security interest in the account to a lender that wishes to perfect by filing a financing statement, then the secured party filing should ordinarily be done under Delaware law because of New York UCC s 9-307(e) and the conflicts rule provided by New York's UCC s 9-305(c)(1). Multi-unit States may by declaration also preserve renvoi elsewhere but this is applicable only under one of the fall-back rules of Art. 5.

41 Article 4(1), second sentence.

activities in general, on the freedom of choice regarding applicable law that the account holder and intermediary might otherwise have. Applicable national substantive law or regulation may well impose additional limits on this freedom of choice, and the Convention does nothing to undermine or invalidate those other limits. As already seen, there is no hint of such a topic in the Article 2(1) issues, and regulatory issues were consciously eschewed throughout the Convention's negotiations.

The Qualifying Office requirement is highly structured. Its central concept, 'regular activity of maintaining securities accounts', is necessarily open-ended in itself, but is also given firmer meaning both by safe harbours and by what is sometimes misleadingly called a blacklist. The safe harbours provide that the Qualifying Office requirement is conclusively met if the office either 'effects or monitors entries to securities accounts', or 'administers payments or corporate actions relating to securities held with the intermediary', such as payment of dividends or facilitating the exercise of voting rights.⁴² Transactional lawyers who want full confidence that a general governing law clause or Hague issues clause will pass muster under the Qualifying Office requirement will want to rely on these safe harbours (and, when issuing a legal opinion, may want to consider making an assumption that the requirement is met, depending on the circumstances). But outside the safe harbours, the Qualifying Office requirement should also be satisfied by an open-ended range of other substantive activities, such as entering into account agreements, or providing advisory and execution services with respect to securities accounts, with the details being determined flexibly in light of evolving market realities.

As a further clarification of the Qualifying Office requirement, certain mechanical functions relating to technology, call centres, mailings and files or archives are singled out in a so-called blacklist as not satisfying the requirement in and of themselves. However, these functions certainly do not disqualify an office from satisfying the Qualifying Office requirement and, when combined with other functions, they may even act as factors that do contribute toward its being satisfied. An office that carries out solely representative functions, or solely administrative functions that are not related to the opening or maintenance of securities accounts, and whose personnel do not have authority to make binding decisions to enter account agreements, does not satisfy the Qualifying Office requirement.

In light of the wide dispersion and inter-office information coordination that characterizes modern securities businesses, the appropriate activities satisfy the Qualifying Office test if they are performed on a regular basis with respect to any securities accounts. In other words, the activities need not relate to the particular securities or securities account that is the subject of the transaction. The activities also qualify even if they are performed together with other offices of the intermediary or of others acting for the intermediary, which may be located anywhere in the world.⁴³

⁴² Article 4(1)(a).

⁴³ *Ibid.* The inclusion of others acting for the intermediary accommodates the increasingly common practice of outsourcing. One must not lose sight, though, of the simple fact that it is the intermediary itself whose office and activities are centrally being

Moreover, the sufficiency of the activities is tested only at the time of the execution of the agreement, rather than at the time of any disposition by the account holder.⁴⁴ The result is to insulate the reliability of the agreed on governing law against disruption from post-closing events such as the closing of an office, and to keep ordinary transactions under established account agreements from triggering a need for bring-down opinions or other follow-up actions.

For account agreements that designate the law of a territorial unit of a Multi-Unit State, the Qualifying Office test is made flexible in an additional way. The office that carries out the qualifying activity need not be located within the particular territorial unit that the agreement designates, and instead may be located in some other territorial unit of the Multi-Unit State.⁴⁵ For example, an account agreement designating the law of California is effective even if the intermediary has no Qualifying Office in California, but only in New York.

Finally, the Qualifying Office requirement is satisfied if the office is identified as maintaining securities accounts in the State, whether by an account number or bank code or other specific means.⁴⁶ This provision is an alternative safe harbour that does not depend on a direct inquiry by the parties into the intermediary's activities.

On the whole, the Qualifying Office requirement is fairly minimal, and in general parties to transactions should be able without undue effort to reach the needed level of certainty on whether it is satisfied.

3. Fall-back rules and pre-Convention agreements

The fall-back rules

The general governing law clause and the Hague issues clause are the tools that well-advised transactional lawyers will generally use in order to take fullest and most certain advantage of the Convention. But the Convention also supplies fall-back rules for account agreements that do not use either of those clauses. In keeping with its transactional focus this article will look only quickly at the fall-back rules.

The first fall-back rule applies if the account agreement is in writing and contains what might be called an entered-through clause, ie a clause that expressly and unambiguously states that the intermediary entered into the account agreement through a particular office. In that case, the law that applies to the Article 2(1) issues is the law in force in the

looked to. The fact that a subsidiary or other affiliate of the intermediary has an office and activities in the applicable jurisdiction is not, itself, sufficient.

44 Ibid. However, if the parties to the account agreement agree to an amendment that would change the law applicable to the Art. 2(1) issues, the Qualifying Office requirement applies as to the jurisdiction of the new law at the time of the amendment. This follows from Art. 4(1) itself, and a contrary rule would be an invitation to abuse. Details as to the conflict of laws effects of such an amendment are provided by Art. 7. But such amendments may prove to be fairly uncommon, because parties desiring a change of applicable law can simply arrange for the securities to be re-credited to a different account, as to which the account agreement would designate the new law from the beginning.

45 Article 12(1)(b). A Multi-unit State is, however, permitted to provide by declaration that the Qualifying Office test will be applied without this flexibility when the designated law is one of its own territorial units. Article 12(4).

46 Article 4(1)(b).

State of that office, subject to the Qualifying Office requirement.⁴⁷ The second and third fall-back rules both depend on completely non-contractual factors: the State in which the intermediary is organized, or the State in which the intermediary has its principal place of business, respectively.⁴⁸ The Qualifying Office requirement does not apply to either of these two fall-back rules.

Each of the fall-back rules is designed to bring a definite resolution to the question of what law governs the Article 2(1) issues, for cases in which the parties have not agreed on a general governing law clause or a Hague issues clause or in which the Qualifying Office requirement is not met with respect to the jurisdiction so specified. The first fall-back's entered-through clause also turns on a contractual provision, but with the general governing law clause and the Hague issues clause being available under the Convention instead, there is little apparent reason for drafters of account agreements to use such an indirect means of specifying the applicable law, particularly in light of the more restrictive Qualifying Office test that the entered-through fall-back entails. The Convention accepts entered-through clauses as a fall-back in order to accommodate a somewhat well-established pattern of business that, though it arose in a setting of *lex rei sitae* thinking, can nonetheless be accommodated at this point within the Convention hierarchy.

Pre-Convention agreements

The Convention generally applies to all account agreements, including those concluded before the Convention took its final form or before the Convention reaches its three-nation entry into force.⁴⁹ All such agreements are referred to here as 'pre-Convention agreements'. Though this broad applicability may initially be startling, it is actually a great benefit, not only to the system generally but also to the parties and lawyers generally involved in the particular agreements. To protect these parties against the expense, trouble and possible bargaining impasses of having to amend existing transactions, while also affording the benefits of certainty that the Convention makes possible, is a considerable achievement expressly designed with transactional practice in mind.

Drafting Convention rules for pre-Convention account agreements while also not upsetting the parties' expectations was a delicate task. The variety of clauses that appear in account agreements, and the variety of treatment of those clauses under various national legal systems, not to mention the varying level of foresight that transactional lawyers have had about the Convention's impending effectiveness, all combine to create a complex patchwork. The Convention's most direct tool, the Hague issues clause, was of course not even a glimmer in transactional lawyers' eyes before the Convention was approved and took its final form. On the other hand, Hague issues clauses are now appearing in well-drafted account agreements, even though the Convention has not yet

⁴⁷ Article 5(1). However, in this case the Qualifying Office test is applied only to the designated office itself, without the alternative of looking to other offices that the intermediary may have in the State. Article 5(1) also supplies certain restrictions on what types of contractual provisions may be considered in applying this fall-back rule.

⁴⁸ Article 5(2), (3).

⁴⁹ Article 16(1).

become effective anywhere. At the same time, the Convention's other principal tool, the general governing law clause, has been recognized under the non-Convention conflicts rules of some nations as being dispositive of one or more of the Article 2(1) issues, but not by the non-Convention conflicts rules of other nations. And as a final layer of complication, some national systems recognize account agreement provisions that are neither Hague issues clauses nor general governing law clauses as nonetheless being dispositive of one or more of the Article 2(1) issues.

Against this background, the rules for pre-Convention account agreements include a handful of interpretive rules that, while appearing complex, are nonetheless very well conceived. The first of these interpretive rules is also the most abstract. It treats a provision of a pre-Convention agreement as if it were a Hague issues clause, so long as the law that governs the account agreement treats the provision as determining the law applicable to any of the Article 2(1) issues and the Qualifying Office test is met.⁵⁰ In essence, an *à la carte* contractual specification of some but not all Article 2(1) issues, otherwise ineffective under Convention Article 4 but effective under non-Convention law, is bootstrapped for pre-Convention agreements into a fully effective Hague issues clause. Because the Convention generally treats all of the Article 2(1) issues as a unified package, pre-Convention agreements that address only some of the Article 2(1) issues needed to be either expanded in their effect or denied effect altogether, and this interpretive rule wisely chooses the former.

The best example is found under US law, where a clause in the account agreement specifying the 'securities intermediary's jurisdiction' is treated as designating the applicable law for a number of commercial law issues concerning the rights and duties of the intermediary and account holder, the perfection and priority of security interests, and the like.⁵¹ Assuming that a pre-Convention agreement's governing law is that of a US jurisdiction and the Qualifying Office requirement is satisfied, then the Convention's interpretive rule treats the securities intermediary's jurisdiction clause as a Hague issues clause—a sound result in light of the effect that the securities intermediary's jurisdiction clause has under the pre-Convention law with which the parties were working when the agreement was reached. On the other side of the same coin, if the account agreement's governing law is other than that of a US jurisdiction (or other than that of some other State that would give similar effect to a securities intermediary's jurisdiction clause), then the Convention's interpretive rule gives no effect to the clause, thereby also accommodating the parties' presumed expectations.⁵²

The second interpretive rule accommodates a pattern in certain European jurisdictions under which the account holder and intermediary agree that the account is maintained in

⁵⁰ Article 16(3).

⁵¹ UCC ss 8-110(e)(1), (b), 9-305(a)(3).

⁵² A similarly significant example is an account agreement's general governing law clause itself, which under US law can also be treated as designating the applicable law for the issues just mentioned. UCC ss 8-110(e)(2), (b), 9-305(a)(3). The general governing law clause is so treated only in the absence of an express securities intermediary's jurisdiction clause as discussed earlier. The relationship between these two rules is closely parallel to the relationship between a general governing law clause and a Hague issues clause as discussed in section 2.

a particular State. Pre-Convention agreements to this effect, even if not express but rather implied from the contract as a whole or from the circumstances, are treated as fully effective Hague issues clauses.⁵³ Like the first interpretive rule, this one operates only if the Qualifying Office requirement is satisfied for the applicable State. But unlike the first interpretive rule, it is not dependent on the content of that or any other State's non-Convention law.

Finally, also in the interest of accommodating the intent behind pre-Convention account agreements, the Convention affords well-informed transacting parties the opportunity to opt out from these interpretive rules altogether. Specifically, if a pre-Convention agreement makes express reference to the Convention, then the interpretive rules will not apply.⁵⁴ The reason is that parties that by hypothesis are already aware of the Convention can presumptively manage its effects on the pre-Convention agreement directly, just as well as parties to post-Convention agreements can. Interpretation that is unneeded can risk becoming distortion. Though in theory this provision would allow the drafter of an account agreement who does not want the Convention's interpretive rules to simply opt out of them, without drafting an affirmative provision for the applicable law, in practice such a drafter should actually go further and simply include a general governing law clause or a Hague issues clause (while also ensuring whether therein or elsewhere that the agreement makes express reference to the Convention). To simply opt out without more is to leave the governing law to the Convention's fall-back rules, and even if these do point to the jurisdiction that the drafter desires, there is no sound reason to try to get there on the more complex back roads of the fall-back rules rather than on the main highways of Article 4.

The same recommendation applies to all drafters of account agreements during this pre-Convention period, quite independently of a drafter's stance toward the interpretive rules. There is little reason today for drafters of account agreements not to include a general governing law clause or a Hague issues clause or both, and good reason for them to do so. Once the Convention begins to become effective under the law of various jurisdictions, those who have taken straightforward advantage of its possibilities will be the most straightforwardly and securely protected. Those who have not will be left, at best, to hope that the complex interpretive rules are correctly applied in the event of a dispute.

4. Conclusion

Occasionally when first learning of a new international conflict of laws instrument, a lawyer sceptically assumes that it will require him or her to spend more time and money

⁵³ Article 16(4).

⁵⁴ Article 16(2). In courts of a State that has made a declaration under Art. 16(2), the interpretive rules will also not apply to 'gap period' account agreements, ie, those that are entered into after the Convention's three-nation entry into force but before its entry into force for the particular State. If litigation is foreseeable in a particular State, it could be advisable to determine whether it has made such a declaration, and to consider amending the account agreement so that it functions correctly under the Convention directly, without the interpretive rules.

coordinating with lawyers from other jurisdictions. But usually, and as is certainly the case with the subject matter of the Hague Securities Convention, the need for taking other jurisdictions into account has in fact been present all along. Far from creating any new conflict of laws issues, the Convention simply clarifies and resolves the conflicts issues that have been murkily and intractably present ever since the emergence of intermediated securities holdings.

Moreover, the resolutions that the Convention brings about all tend directly toward simplifying transactions and reducing the number of implicated jurisdictions. As the list of jurisdictions ratifying the Convention gets under way and begins to increase, the number of bodies of possibly applicable law will diminish. Without the Convention, it is a rare transaction in which a lawyer can confidently assure his or her client that the applicable law is definitively that of a single given jurisdiction irrespective of the forum. But under the hypothetical condition of universal ratification, such assurance could be given in every transaction for all of the Article 2(1) issues. Of course that hypothetical condition is a very far-fetched one, but the principle that it illustrates remains accurate, and well-advised lawyers should already be drafting their agreements so as to benefit from what one hopes will be widespread ratification.

Lessons from Cukurova

Joanna Benjamin and Felicity Maher*

Key points

- The recent decision of the High Court of the British Virgin Islands in *Alfa v Cukurova* has caused a stir among lawyers serving the international financial markets based in London.
- The decision concerns the meaning of 'appropriation'. Appropriation is a new remedy for collateral takers introduced by the Financial Collateral Arrangements (No. 2) Regulations 2003, which implement the Financial Collateral Directive.
- The decision holds that effective appropriation requires the collateral taker to take over from the collateral giver the ability to deal with the collateral as its own.
- In *Cukurova*, where an equitable mortgage was taken over directly held shares, this required that the collateral taker become the registered owner of the shares.
- The decision was appealed to the BVI Court of Appeal in late January 2008 and may go further. In the meantime, this article provides an overview of the decision and considers its wider significance.

1. Introduction

'It is far better to be possessor than to be plaintiff.'¹ The truth of this was recently demonstrated to the Alfa Group in the case of *Alfa v Cukurova*.² This British Virgin Islands (BVI) decision concerned a dispute over shares in two companies, one incorporated in Turkey and the other in the BVI. The litigants were not financial institutions, and the shares were unlisted. Although the facts may seem a long way from the international financial markets based in London, the decision has caused a stir among the lawyers who serve those markets. The decision turned on the meaning of 'appropriation' for the purposes of the UK Financial Collateral Arrangements (No. 2) Regulations (FCAR).³ Reports were received from Lord Millett and Professor Ross Cranston as foreign law experts.⁴ Emails on the implications of the case are flying, law firms are hastening to brief their clients, and a Financial Markets Law Committee⁵ working party has been established. This article will provide an overview of the case, and consider its significance, with particular reference to the nature of appropriation, indirectly held securities, the Financial Collateral Directive (FCD) regime, the

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1 Peter Birks and Grant McLeod (trs), *Justinian's Institutes* (Duckworth, London, 1987) 143.

2 *Alfa Telecom Turkey Limited v Cukurova Financial International Limited and Cukurova Holdings A.S., Cukurova Finance International Limited and Cukurova Holdings A.S. v Alfa Telecom Turkey Limited*. The High Court of the British Virgin Islands, 2007, Claim No.s 072, 119, judgment of Joseph-Olivetti J.

3 SI 2003/3226.

4 Although, heart-warmingly, the judge commented that '... English law is never really regarded as foreign law in these courts'. *Cukurova* Para 17.

5 www.fmlc.org.