AMERICAN BAR ASSOCIATION
ADOPTED BY THE HOUSE OF DELEGATES
August 11-12, 2003

RESOLVED, That the American Bar Association supports the prompt signature, ratification, and implementation of The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary by the United States and by other countries.

REPORT

I. INTRODUCTION

On December 13, 2002, the Hague Conference on Private International Law adopted its 36th Convention: On the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary. ("the Hague Convention"). The Hague Convention provides workable and uniform choice-of-law rules that, in effect, internationalize the approach taken in Articles 8 and 9 of the Uniform Commercial Code ("UCC") for securities held through intermediaries. This uniformity will facilitate many cross-border financial transactions, which rely on securities as collateral.

In terms of dollar volume, financial transactions—payments, derivatives, repos, securities transfers, and the like—dwarf all other transactions. Nevertheless, in the U.S., these transactions are low-risk, thanks to collateralization, a high degree of operational integrity and a very precise body of governing law. Generally, these transactions are collateralized with securities held through intermediaries. The risk of these transactions, however, increases substantially in cross-border transactions, because current international choice-of-law rules are disparate and often unpredictable in application. The Hague Convention is aimed directly at reducing this risk. It does not prescribe substantive law for securities intermediaries, but rather selects a unique governing law for a transaction, permitting avoidance of unsafe legal regimes, and encouraging the adoption of safe legal regimes, such as that provided by the UCC.

A significant accomplishment of the Convention was gaining consensus on choice of law principles for securities held with intermediaries based not upon the location of the securities but upon the "place of the relevant intermediary," also known as the "PRIMA" approach.

The primary rule of the Convention for determining the applicable law is to look to the law in force in the jurisdiction expressly agreed in the agreement between the customer and the intermediary governing the securities account, provided that minimal support can be established for the choice of that law. That support could be in the form of an office that performs certain functions in that jurisdiction, even if those functions are unrelated to any particular account. If the applicable law is not determined in this manner, there are certain fall-back provisions in the Convention that would result, ultimately, in the applicability of the law of the jurisdiction in which the intermediary is organized. The Convention provides fairly detailed provisions as to how these determinations are to be made, including factors that are to be disregarded in the analysis.

II. BACKGROUND

The Convention follows the approach to choice of law for the indirect holding system that was adopted in U.S. law by the 1994 revision of Article 8 of the UCC. Under Revised Article 8, and corresponding provisions of Article 9, the law governing transfers of securities held through intermediaries and the perfection of security interests in securities held through intermediaries is the law of the securities intermediary's jurisdiction. Revised UCC Article 8 also permits the intermediary and customer to determine the intermediary's jurisdiction by agreement. The Revised UCC rules on choice of law are, however, necessarily limited in effect and unlikely to be applied outside the United States. U.S. securities firms, banks, and other entities engaged in transnational securities holding have faced the risk that if litigation occurs in a non-U.S. forum, the court might apply older choice of law principles that do not take account of the realities of the modern indirect holding system. Adoption of the new Hague Convention will eliminate that risk by requiring all signatory States to apply modern choice of law rules, akin to those adopted by the Revised UCC. There, are, of course, some respects in which the Hague Convention choice of law rules differ from those of the Revised UCC, but such differences are matters of detail, not fundamental approach.

Historically, securities were for the most part held in physical form, and the location of these assets was readily identifiable. A transferee of securities or a creditor seeking to establish an interest in securities would logically look to the law of the place of the actual physical location of the security. Financial markets have expanded and moved to book-entry securities holdings maintained through clearing and settlement systems (and other intermediaries), and away from physically identifiable securities. In the movement towards book-entry systems, it has become increasingly difficult for financial market participants to determine what law would apply to transactions involving an interest in securities held through these systems. Given the potential applicability of laws of several jurisdictions, the costs of compliance are significant, and still provide very little certainty as to the rights of investors, creditors and other financial market participants.

An in-depth summary of The Hague Convention is provided as an Appendix to this report.

III. U.S. IMPLEMENTATION

The U.S. Department of State has not yet transmitted The Hague Convention to the U.S. Senate for its advice and consent. The Administration is pleased that the American Bar Association ("ABA")'s Section on International Law and Practice has endorsed The Hague Convention – and, is hopeful that the entire ABA, through approval of this recommendation at this meeting -- will endorse The Hague Convention. The U.S. Department of State expects to transmit The Hague Convention to the U.S. Senate in the fall of 2003 with appropriate declarations.

The Hague Convention requires no Federal implementing legislation or changes to the Uniform Commercial Code or other state law.

IV. COORDINATION

The ABA Section on Business Law and the National Conference of Commissioners on Uniform State Law are apprised of The Hague Convention, and members of both bodies participated in its negotiation. We are aware of no opposition to The Hague Convention in these groups or elsewhere in the ABA. The Section on Business Law is prepared to consider this resolution at the ABA Annual Meeting in San Francisco this August. It is fully expected that the

Section on Business Law will support this resolution and second any effort by the Section on International Law and Practice to gain passage by the ABA House of Delegates.

V. CONCLUSION

The Convention will contribute to the urgent practical need in the large and growing global financial markets for greater legal certainty as to the laws applicable to interests in securities held through indirect holding systems, and will reduce legal risk, systemic risk and costs of cross-border securities transactions. The result will facilitate the flow of capital to both developed and emerging markets.

Given the ABA's support for private international law initiatives, including efforts that clarify choice-of-law rules for legitimate cross-border financial transactions, it is appropriate for the ABA to give its strong support to the implementation of The Hague Convention.

Respectfully Submitted,

Don S. DeAmicis

Chair

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APPENDIX: COMPREHENSIVE SUMMARY OF THE HAGUE CONVENTION

Article 1 Definitions and interpretation

Article 1 contains definitions and interpretive provisions.

The key definition is "**securities held with an intermediary**," which the Convention defines as "the rights of an account holder resulting from a credit of securities to a securities account." The operative provisions of the Convention specify the law governing rights in respect of dispositions of "securities held with an intermediary," that is, the Convention determines the applicable law only with respect to an investor's rights—however described in the substantive law—that result from the credit of securities to the investors securities account. The Convention does not say anything about how the applicable law <u>describes</u> the rights that result from a credit of securities to a securities account. As applied to US law, the term in "securities held with an intermediary" is essentially equivalent to the Revised UCC Article 8 concept of a "securities entitlement."

Other definitions in Article 1 are components of the key concept of "securities held with an intermediary." "**Securities account**" is an account to which securities may be credited or debited, and "**account agreement**" is the agreement governing the securities account. "**Account holder**" is the customer. "**Intermediary**" is a person that maintains a securities account, and "**relevant intermediary**" is the intermediary that maintains the securities account for the account holder. Finally, "**securities**" is defined as "any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein." It is important to note that the scope of the Convention is not determined by the term "security" but by the term "securities held with an intermediary." Local law, not the Convention, will determine what forms of property can be held in a securities account. Thus, the function of the definition of "securities" is only to be sufficiently broad to cover the various forms of assets that local law permits to be carried in a securities account. The exclusion of cash is intended to preserve the distinction between securities accounts and ordinary bank deposit accounts.

"**Disposition**" is defined to cover both outright transfers and security interests. The term is also made broad enough to cover transactions, common under United Kingdom law, in which title to securities is transferred, but this is done for purposes of security. Note that while "disposition" is defined broadly, the relevant operative provisions make clear that the Convention determines the applicable law only with respect to a "disposition" of "securities held with an intermediary," that is, the Convention says <u>nothing</u> about transfers or security interests in securities held directly. "**Perfection**" is defined as "completion of any steps necessary to render a disposition effective" against third parties. In US practice and law, the concept of perfection could apply only to security interests. The Convention defines the term more broadly, with respect to any "disposition," to include transactions such as the UK device of title transfer by way of security.

Article 1 also includes several provisions designed to eliminate doubt on a number of potential issues concerning the scope of the Convention. Article 1(2) provides that "disposition" includes (i) a disposition of an entire securities account rather than particular positions, (ii) a disposition in favor of the account holder's intermediary, as in the common case in which an account holder grants its own intermediary a security interest in positions held through the account, and (iii) a lien by operation of law in favor of the intermediary arising from operation of the account.

Article 1(3) was included primarily to cover a holding pattern found in certain countries in which an entity that might otherwise be seen as acting as a central securities depository is, under local law, regarded as acting only as a transfer agent, such that the persons recorded on the books are treated as direct holders rather than holding through a securities account with an intermediary. Article 1(4) is intended to make clear that a central securities depository is treated as an intermediary. Article 1(5) is included solely to address a problem that arises in some countries (not the US). For example in the United Kingdom, the CRESTCo Ltd system acts in different capacities for United Kingdom and Republic of Ireland issuers of securities. Article 1(5) permits the country whose law governs the issuance of particular securities to declare that CRESTCo does act as an intermediary with respect to particular securities of that issuer.

Article 2 Scope of the Convention and of the applicable law

Paragraph 1 of Article 2 sets forth the scope of the Convention, listing the issues that are to be determined by the law designated by the Convention in Articles 4 and 5. These issues are in large measure a combination of the issues determined by the "securities intermediary's jurisdiction" under Articles 8 and 9 of the Uniform Commercial Code (i.e., a combination of Section 8-110(b) and Section 9-305). Seven issues are included in this list:

a) the legal nature and effects against the intermediary and third parties of credits to securities accounts

b) the legal nature and effects against the intermediary and third parties of dispositions of securities held with an intermediary,

c) the requirements, if any, for perfection of such dispositions,

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

e) any duties, if any, of an intermediary to third parties asserting interests in the securities held with the intermediary,

f) the requirements, if any, for realization of the recipient's interest, and

g) whether a disposition extends to rights to payments in respect of and proceeds of a disposition of securities held with an intermediary.

The first two are the heart of the Convention. They insure that the law determined under Article 4 or 5—in essence, the law of the intermediary's jurisdiction—will determine the legal consequences of a credit of securities to a securities account or a disposition (which includes creation of a security interest) of securities held with an intermediary. If, for example, the intermediary's jurisdiction is in the U.S., then U.S. law will determine the effect of crediting securities to a securities account. Under U.S. law, the relevant provisions would be the provisions of revised Articles 8 and 9 of the U.C.C. dealing with indirect holdings and interests in securities entitlements. That will be so regardless of the location, if any, of underlying certificates or the jurisdiction of incorporation of the issuer. That result will follow in any case in which the litigation occurs in a forum that has ratified the Convention. The remaining provisions of Article 2(1) provide additional clarifying detail on the matters covered by the Convention.

The provision in Article 2(1) (d) that the applicable law under Convention determines "whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest" cover the issues that, in U.S. law, are commonly referred to as "bona fide purchase" issues. It ensures that an investor to whose account securities are credited need look only to the law of the intermediary's jurisdiction to determine whether the investor acquires its interest free from adverse claims. That is an important issue, and one on which existing choice of law rules in jurisdictions outside the U.S. leaves in considerable doubt. Under the choice of law analysis applied in many jurisdictions, the question whether an adverse claim can be asserted must be considered under the law of each of the states that might have been involved in the chain of transactions that resulted in the securities being credited to the investor's account. By contrast, under the Convention if the intermediary's jurisdiction has robust rules cutting off potential adverse claims, then the investor need look to no other body of law for assurance that it has acquired its interest free of adverse claims.

Article 2(1)(e) ensures that the law of the intermediary's jurisdiction determines whether the intermediary owes any duties to a person who asserts an adverse claim to position held through that intermediary. This provision is very important to the safe and sound operation of this holding system. It ensures that an intermediary can look to its own law alone to determine whether it owes any duties to persons asserting adverse claims. For example, U.S. law, in Revised U.C.C. 8-115 generally provides that an intermediary is protected against adverse claims unless the intermediary has been served with legal process or acts in collusion with the wrongdoer. Article 2(1)(e) of the Hague Convention ensures that that rule will be applied to U.S. intermediaries regardless of where the litigation takes place.

Paragraph 3 of Article 2 makes clear that the Convention does not determine the law applicable to the purely contractual or purely personal rights and duties arising from the credit of securities to a securities account or of parties to a disposition; nor does the Convention apply to the rights and duties of an issuer of securities. Paragraph 3 is subject to paragraph 2, which was included to make clear that the Convention determines the law applicable to all of the paragraph 1 issues irrespective of whether the rights resulting from the credit of the securities to a securities account are determined to be contractual in nature under the applicable law.

Article 3 Internationality

Article 3 provides that the Convention applies "in all cases involving a choice between the laws of different States." The text of Article 3 is drafted broadly to maximize the application of the Convention. Article 3 makes clear that the Convention applies, i.e., provides the applicable law, whenever the law of more than one State would apply to the matters within the scope of the Convention under Article 2.

Article 3 does not limit the Convention's application to existing disputes or to the context where, under the forum's private international law rules, there exists a "conflict." Rather, whenever any two of the following factors are in different States, the Convention will apply: (i) the account holder; (ii) any of the parties to a disposition of the securities or the securities account, or an interest in either; (iii) the relevant intermediary; or (iv) the issuer or issuers of the securities. The foregoing list is not exclusive. In a particular fact pattern, additional factors may also produce application of the Convention.

Moreover, the Convention can be brought into application at any point in time. Article 3 ensures that the Convention's application is not limited temporally to the moment of litigation or to the moment of the occurrence of a particular transaction. Rather, the occurrence of circumstances at a point in time after the particular transaction but at a moment, which is otherwise relevant to the situation (e.g., the moment when a later adverse claimant acquired its rights) will also make the Convention applicable. Thus, prudent transacting parties will always consider the possibility that the Convention may already have been brought into application or may thereafter be brought into application, in addition to the possibility that it will be applicable by reason of the circumstances of their particular transaction.

The reference in the text to "cases" means "situations"--it does not mean that the Convention applies only in a judicial proceeding. Quite the contrary; the primary purpose of the Convention is to provide ex ante certainty to transacting parties, and thus it applies whenever there is a choice of law analysis, in or outside of a judicial proceeding.

Article 4 Applicable Law--Primary rule

Article 4 sets forth the “primary rule” determining the law applicable to the matters covered by the Convention: the approach adopted by the Convention is referred to as the “place of the relevant intermediary approach” or “PRIMA.” Basically, the Convention rule is compatible with the approach taken in modern Amercian law, under Revised Articles 8 and 9 of the U.C.C. The applicable law is determined by the intermediary’s jurisdiction, rather than by the location of the underlying securities. This is the fundamental principle of the Convention, and is a matter of enormous practical significance to any persons dealing with securities held in securities accounts. Under the older approach, which may still be followed in many countries, the applicable law is determined by the location of the underlying securities and/or the related issuer. For example, if an investor wishes to use as collateral for a loan a portfolio of securities issued by companies around the globe that the investor holds through a single account with an intermediary, the lender could not be assured that appropriate steps had been to perfect the pledge unless the transaction were examined under the laws of all of the various jurisdictions of the issuers of all of the securities held through the account and the location in which certificates representing the underlying securities might be held. In most cases it is impractical or impossible to go through that analysis. Under the PRIMA rule of the Convention, one need only look to the law of a single state—the intermediary’s jurisdiction. This fundamental choice of law rule is equivalent to the approach taken in the U.S., under Revised Articles 8 and 9 of the U.C.C., and under the law of other jurisdiction which have modernized their domestic substantive and choice of law rules to take account of the realities of the modern holding system.

The Article 4 rule begins by saying that the law applicable to the issues specified in Article 2 is "the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law." In most cases, only the first part of the clause will be relevant, that is, the governing law is the law of the jurisdiction whose law is selected as the governing law of the account agreement. The second clause was included primarily to cover a pattern found in some countries where the law of another state is selected for contractual matters under the agreement, though that selection is not intended to determine the intermediary's jurisdiction for purposes of the issues governed by the Convention. This approach is similar to that reflected in Section 8-110(e)(1) and (2) of the UCC, which permits the parties to select as the "securities intermediary's jurisdiction" the law of a jurisdiction different from the law selected to govern the account agreement itself.

It is important to note that the Article 4 rule determining the intermediary's jurisdiction turns on the agreement between the customer and the intermediary that maintains the account. If that customer holds securities through an account with a broker and wishes to use its holdings as collateral for a loan from a lender, the Article 4 test provides that the governing law is determined by the agreement between the customer and the broker concerning the account, not the agreement between the customer and the lender.

The difference between existing U.S. law and the Hague Convention is that under U.S. law, the securities intermediary's jurisdiction can be determined entirely by agreement between the intermediary and customer. Under the Hague Convention there is an additional requirement, colloquially known as the "reality test." This limited test provides that the selection of governing law in the account agreement is effective only if certain minimal conditions are met concerning the relationship between the relevant intermediary and that jurisdiction. The first requirement is that the intermediary has an "office" in the jurisdiction selected. Under Article 2(1) "office" means a place of business of the intermediary, excluding a place which is intended to be "merely temporary."[1] The second component of the reality test is that the intermediary carries out at that office certain functions relating to the maintenance securities accounts generally. There are two sets of factors: positive (setting out the types of activities the office must be engaged in, including the making of entries to securities accounts, administering payments or being "otherwise engaged in a business or other regular activity of maintaining securities accounts" and as an alternative permitting identification through an account number, bank code or other specific means of identifying the office as one which maintains securities accounts in the chosen State) and negative (setting out what activities do *not* constitute "being engaged in a business or other regular activity of maintaining securities accounts").

It is worth noting that the positive component of the reality test is satisfied if the intermediary "is otherwise engaged in a business or other regular activity of maintaining securities accounts." In essence this last component is not a specific illustration, but a general

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[1] Article 2(1)(j) also contains the essentially self-evident proposition that "office" excludes a "place of business of any person other than the intermediary."

reference to the concept that the intermediary "maintains" securities accounts at that location. In most cases the two specific components of the reality test should suffice to permit a confident conclusion that the intermediary's operation at a particular place qualify. Where that is not the case, the final component permits a conclusion that the reality test is satisfied so long as one can determine that the intermediary's activities at that place suffice as "a business or other regular activity of maintaining securities accounts."

A special rule is included as Article 4(3) to address the situation in which an account holder disposes of securities in favor of its own intermediary. Under this provision the intermediary itself is considered the relevant intermediary and the account agreement between the account holder and that intermediary is considered the relevant account agreement and the securities account to which the fall-back rules (discussed below) refer is the securities account to which the securities were credited immediately before the relevant disposition. This rule applies "whether or not that intermediary maintains a securities account on its own records for which it is the account holder." The rule in Article 4(3) was designed to avoid a different result in the application of the relevant law under Articles 4 and 5 being generated solely by a difference in the nature of the disposition (e.g., pledge – in which case the securities are often left credited in the account holder's account, vs. collateral assignment by way of title transfer, in which case the securities are often debited from the account holder's account) or whether the intermediary in fact opens an account in its own name on its own books vs. a less formal ledger-type entry indicating that the securities are the subject of a disposition between the intermediary and the account holder.

Article 5 Applicable Law--Fall-back rules

Article 5 of the Convention contains a set of "fall-back" rules that apply when Article 4 does not determine the law applicable to the Article 2 issues. This can occur if the parties have not expressly agreed upon a governing law in the account agreement, or if the agreement as to governing law is ineffective for purposes of the Convention by reason of failure to meet the local office test. Article 5 also provides the fall-back rules when the analysis of pre-Convention account agreements and securities accounts under Article 16 (discussed below) fails to produce a result.

Article 5(1) provides that if the parties "expressly and unambiguously" agree in writing that the intermediary entered into the account agreement through a particular office, then the law of that office's location will govern the Article 2 issues, provided that the office meets the "reality test" of Article 4. In an effort to simplify the diligence process, Article 5(1) also lists a series of provisions commonly found in account agreements, such as notice provisions and consents to jurisdiction for legal process, that are not to be considered in determining whether the account agreement is "express and unambiguous."

If Article 5(1) is not applicable, Article 5(2) provides that the law of intermediary's place of incorporation or organization will govern the Article 2 issues, unless the intermediary does not have legal personality in which case the law of its place of business (or its principal place of business if it has more than one place of business) will govern the Article 2 issues. As is the case for the primary rules in Article 4, the choice of law in both fall-back provisions is fixed at the time the account agreement is executed or, in the absence of a written agreement, at the time the relevant securities account is opened. A final detail in Article 5(3) provides that if the intermediary is incorporated under the laws of a Multi-unit State (as opposed to one of its territorial units), then the Article 2 issues will again be governed by the laws of the territorial unit in which the intermediary has its place of business (or its principal place of business if it has more than one place of business).

Article 6 Factors to be disregarded

Article 6 sets forth "factors to be disregarded" in a manner similar to the list of factors to be disregarded under Section 8-110(f) in determining the "securities intermediary's jurisdiction" under Section 8-110(e) of the UCC. The factors to be disregarded include (1) the place where the issuer is located, (2) the place where security certificates are located, (3) the place where any securities register is located (4) the place where any intermediary other than the relevant intermediary is located.

Strictly speaking, Article 6 is unnecessary given that the basic rule of the Convention is that the applicable law is that of the intermediary's jurisdiction. However, the U.S. delegation to the Convention felt strongly that it was useful and important to have specific Convention text that explicitly rejected the "look-through" approach that has in the past been applied to choice of law for securities held with intermediaries.

Article 7 Protection of rights on change of the applicable law

Article 7 deals with the effect of a change in the governing law under the Convention. Because the basic choice of law rule in Article 4 turns, in part, on the selection of governing law in the account agreement, it is theoretically possible that the parties to an account agreement will change the governing law to the prejudice of a third person not party to those arrangements who nevertheless relied on the assumption that the governing law was that determined under the prior version of the agreement. It is likely, however, that the third person will have taken steps to ensure that the account holder cannot take action that will result in a change in governing law without the third person's agreement. If the third person has not take any such steps – such as having the securities positions moved into an account over which it has exclusive control, or requiring that its consent be obtained before any change in the law governing the account is made – then it is likely that a change in governing law is a risk already subsumed in larger risks (such as the account holder's transfer of all securities held in that account) the third person in such a case has agreed to accept.

Nevertheless, the Convention does include in Article 7 rules designed to protect a secured party or other transferee against potential adverse effects of a change in law. Article 7 was included in the Convention primarily for the benefit of countries, unlike the United States, where it is said to be the case that the means of establishing a security interest do not as readily permit a secured party to eliminate the problem of change in law by practical measures. In the U.S., Article 9 of the UCC generally provides certain grace periods to address these issues.

Article 7 begins, for drafting convenience, by defining the terms "old law" and "new law" as, respectively, the law determined under the Convention before and after the change in the agreement. The most important part of Article 7 is subsection (3), which provides that, except as stated elsewhere in Article 7, the new law governs all of the issues governed by the Convention. For example, if a transfer is made to SP1 under old law and then, after a change in law, a transfer is made to SP2 under the new law, the new law determines the priority of the claims of SP1 and SP2.

Article 7(4) states the exceptions to that general rule – that is, the circumstances in which the old law continues to determine the rights of a transferee even after a change in the governing law. The most significant such cases are those in which there is no disposition to a new transferee under the new law. Thus, the old law continues to apply to determine the rights of the transferee against (i) the intermediary and any other pre-change interest, (ii) an attaching creditor, and (iii) an insolvency administrator. Moreover, Article 7(4)(a) provides that the old law determines whether an interest created under old law is perfected, although a priority dispute between an old interest and a new interest would be determined by the new law.

Article 8 Insolvency

In Article 8(1), the Convention affirms that its choice of law analysis applies to any event that occurs prior to the opening of an insolvency proceeding (which is a defined term in Article 1). However, Article 8(2) provides that the law of the insolvency forum State (or the choice of law rules of the forum State) shall govern "substantive or procedural" rules relating to the ranking of claims, voidable transactions such as preferences and fraudulent conveyances and statutory or judicial stays on realization of collateral, which are common provisions in most bankruptcy codes. Thus, even if a creditor had properly perfected its security interest under the law governing the Article 2 issues, that security interest would be subject in a case under the United States Bankruptcy Code, for example, to the automatic stay and to avoidance as a preferential transfer.

Article 9 General applicability of the Convention

Article 9 provides that the Convention applies whether or not the law determined to be applicable is that of a State which has adopted the Convention. This is a standard provision in Hague Conventions on choice of law.

Article 10 Exclusion of choice of law rules (renvoi)

Article 10, which is also standard in Hague Conventions on choice of law, provides that the "law" to be applied by operation of the Conventions rules is the law in force in a State other than its choice of law rules. This is similar to the choice of law rules in Articles 8 and 9 of the UCC, which refer to the "local law" of the selected jurisdiction.

Article 11 Public policy and internationally mandatory rules

Article 11 deals with the extent to which a forum court may decline to apply the Convention's choice of law rules or grounds of public policy of the forum. The first two subsections of Article 11 are standard provisions in private international law conventions.

Subsection (1) provides that a forum state can refuse to apply the substantive law determined under the Convention only if application of that law would be "manifestly contrary to the public policy of the forum." Subsection (2) provides that the Convention does not preclude application of rules of the forum that would be applied irrespective of conflict of law rules. There is a strict standard of interpretation in international practice regarding matters that can appropriately qualify for this treatment and it is not often used.

The more significant feature of Article 11 is found in subsection (3), which provides that the exception for rules of public policy and internationally mandatory rules does not apply to rules of the forum relating to perfection and priorities.[2]

Article 12 Determination of the applicable law for Multi-unit States

Article 12 contains a number of essential interpretive rules for the context of a Multi-unit State, and authorizes a Multi-unit State to make certain declarations in relation to those rules.

The term Multi-unit State is defined in Article 1 as a nation-State within which there is more than one set of laws governing the issues specified in Article 2. The various sets of laws can appear either among a nation-State's different territorial units (such as the states of the United States of America or the provinces of Canada) or between different levels of government and different subject areas (such as the U.S. federal laws that apply to U.S. Government and Agency securities and the state laws in the United States that apply to state, municipal and private sector corporate securities). The fundamental interpretive rule of Article 12 relates to Article 4, and provides that, when an account agreement specifies it is to be governed by the laws of a territorial unit, (1) the laws of that territorial unit shall be the law applicable to the Article 2 issues, but (2) that the local office requirement of Article 4 applies to the Multi-unit State as a whole. Thus, if an account agreement specifies, for example, that it is governed by the law of New York, that designation will be effective under Article 4 if the intermediary has an appropriate office anywhere within the United States. Article 12(1) thereby leaves unaffected the many U.S. law-governed agreements that choose the law of a specific state, for example New York, to govern the account agreement (or to constitute the "securities intermediary's jurisdiction") in circumstances where the relevant intermediary may not have an appropriate office within New York, which would not be required under Article 8 of the Uniform Commercial Code, but does have such an office in another state of the United States.

Article 12(2) addresses matters of concern largely to the United States and a few other countries. First, Article 12(2)(a) provides that a territorial unit's law will import the law of the

[2] For example, a debtor grants a security interest in shares of a company which is incorporated under the law of a Country X. Under the law of Country X, no security interest in a corporation organized under its law will be recognized unless recorded on the books of the company or its registrar. However, Debtor holds those shares through an account with an intermediary and the Convention's primary (or fall-back) rules (Articles 4 and 5) would result in the application the law of the intermediary's jurisdiction, which would be Country Y. Under Country Y's law, the security interest can be perfected by control; no registration on the books of the Company or its registrar is required. Under Article 11(3) of the Convention, the choice of law rules in Articles 4 and 5 of the Convention must be applied even by the courts of Country X. Country X would not be permitted invoke the public policy exception to apply its rule on perfection.

Multi-unit State itself to the extent applicable in the territorial unit. Thus, federal law pre-emption in the context of U.S. Government and Agency securities is preserved. Second, Article 12(2)(b) preserves choice of law rules internal to a Multi-unit State in respect of perfection by filing. Accordingly, if the Convention's primary or fall-back rules point to a particular state in the United States as the law applicable to the Article 2 issues, Article 12(2)(b) preserves the application of the choice of law rules in that state (e.g., UCC Section 9-305(c)(1)) to determine that the law of another state will govern perfection by filing (e.g., in the jurisdiction of the debtor's organization as specified in UCC Sections 9-301 and 9-307). This is an important savings clause for United States.

Article 12 permits certain declarations to be made. Under Article 12(4), a Multi-unit State (for example, Canada) may make a declaration to the effect that, contrary to Article 12(1), the local office requirement applies to the territorial unit in which the intermediary is located. Article 12(3) permits a Multi-unit State to make a declaration as to how its internal choice of law rules will operate between or among the substantive rules of its territorial units or of the Multi-unit State itself when the Article 5 fall-back rules come into play because there has been no agreement by the parties to a specific governing law. The Article 12(3) declaration, if made, "shall communicate information concerning the content of those internal choice of law rules".

Article 13 Uniform Interpretation

Article 13, a standard provision in Hague Conventions on choice of law, provides that in interpreting the Convention "regard shall be had to its international character and to the need to promote uniformity in its application".

Article 14 Review of practical operation of the Convention

Article 14, a standard provision in Hague Conventions on choice of law, provides for the permanent bureau of the Hague Convention to convene meetings to review the operation of the Convention.

Article 15 Application of Convention Rules

Article 15 deals, to a limited extent, with the question whether the rules of the Convention apply retroactively or only prospectively. Article 15 provides that the substantive law determined under the Convention rules does apply to a dispute between an interest acquired after the Convention comes into effect and an interest acquired before the Convention comes into effect. Thus, the Convention assures that any party who takes a transfer after the Convention comes into effect can look to the Convention rules to determine the applicable law and can be assured that the applicable law will apply not only to disputes with other port-Convention interests, but also to any dispute between the post-Convention interest and any pre-Convention interests.

As applied to litigation in United States courts, however, it is extremely unlikely that any genuine transition issues will be presented. Prior to the effectiveness of the Hague Convention, the choice of law rule that would be applied by a court within the United States would be the choice of law rule set out in the Uniform Commercial Code. Since the enactment of Revised Article 8, that rule has embodied the basic PRIMA principle.

It is very important to realize that Article 15 of the Hague Convention does not affirmatively state any general rule to the effect that the Convention is to be given only prospective effect. Rather, Article 15 states one situation that is to be governed by the Convention rules, even though some impact on pre-Convention rights may be involved. Beyond that point it is left to the domestic law of the forum state whether to apply the Convention rules or to apply pre-Convention rules.

In fact, it is not anticipated that many significant transition issues will arise in practice. The point of the Hague Convention is not to make a change from one settled state of the law to another settled state. Rather, the point of the Convention is to remove obstacles and uncertainty that, under some systems of law, stand in the way of application of the PRIMA principle that is universally agreed is the only feasible approach to choice of law for securities held with intermediaries.

Article 16 Pre-Convention account agreements and securities accounts

Under the basic rule of Article 4, the parties to an account agreement can include an explicit provision specifying the law that will govern the issues covered by the Convention. It can be expected that as the Convention comes into effect, account agreements will be revised to take specific advantage of the provision permitting selection of governing law by agreement, subject to the local office test. The Convention must also apply, however, to transactions where the relevant account agreement was entered into before the Convention came into force. Article 16 sets forth a series of transitional rules specifying how pre-Convention account agreements are to be interpreted by courts once the Convention comes into force in that forum. Article 16(2) makes clear that the transitional rules do not apply if the account agreement makes express reference to the Convention.

Article 16(3) sets out a transitional rule designed primarily with U.S. account agreements in mind, that is, agreements that were entered into in contemplation of the choice of law rules contained in Revised U.C.C. Articles 8 and 9. Article 16(3) provides that if the agreement contains a provision that would have the effect under its governing law—e.g., under U.S. law as set out in the UCC—that the issues covered by the Convention are governed by a particular law, then the agreement shall be treated as if it referred to the Hague Convention and selected that law. For example, parties operating under Revised Articles 8 and 9 of the UCC might include in their account agreement a provision specifying that “the securities intermediary’s jurisdiction” is New York. Since the Hague Convention uses a slightly different formulation there might be some doubt whether a pre-Convention agreement has the expected effect under the Convention. Article 16(3) is designed to remove doubt on this score.

Article 16(4) sets out a transitional rule intended primarily for non-US agreements. Under Article 16(4), if an agreement provides that “the securities account is maintained in a particular state” then the agreement shall be treated as if it referred to the Hague Convention and selected that law.

The drafting of Article 16 seems more complex than its basic objectives. The complexity is due primarily to the need to accommodate various different patterns of agreements that might be found in different jurisdictions. Thus Article 16 provides that a State may, upon ratification of the Convention, make various declarations limiting the effect of Article 16. It is anticipated that the U.S. will make no such declaration, so that the applicable transitional rules will be those set out in Article 16(3).

Article 17 Signature, ratification, acceptance, approval or accession

This article, standard in Hague Conventions, provides the technical rules describing the way in which a State can become bound by the Convention, thus becoming a "Contracting State".

Article 18 Regional Economic Integration Organisations

Article 18 deals with the way in which a Regional Economic Integration Organisation (such as the European Union) can become bound by the Convention to the extent such Organisation has competence over matters governed by the Convention.

Article 19 Entry into force

This article provides that the Convention will enter into force on the first day of the month following the expiration of three months after three States have become Contracting States. Thereafter, the Convention will enter into force in a State on the first day of the month following the expiration of three months from completion of the steps necessary for the State to become a Contracting State.

Article 20 Multi-unit States

Article 20 permits Multi-unit States to apply the Convention by way of declaration to all or only to certain of its territorial units. If not declaration is made, the Convention will apply to all such territorial units. The United States will not need to make such a declaration.

Article 21 Reservations

No reservations are permitted in this Convention, meaning that a Contracting State will be generally subject to the entire Convention, except where declarations are made as permitted for certain articles.

Article 22 Declarations

Article 22 permits provides the technical rules governing the manner in which the various declarations permitted to be made under the terms of the Convention become effective, modified or withdrawn. All declarations must be notified in writing to the Depositary of the Hague Convention and, for declarations made subsequent to becoming a Contracting State, do not become effective until the first day of the month following the expiration of three months after the date on which the Depositary makes notification in accordance with Article 24.

Article 23 Denunciation

Article 23 permits a Contracting State to withdraw from the Convention for itself or any of its territorial units by notification in writing to the Depositary, which denunciation will become effective only on the first day of the month following the expiration of twelve months after the date on which the notification was received by the Depositary.

Article 24 Notifications by the Depositary

This article provides for notification to the Members of the Hague Conference on Private International Law, and other States and Regional Economic Integration Organisations with respect to which the Convention has become effective, of various actions in connection with the Convention.

GENERAL INFORMATION FORM

Submitting Entity: Section of International Law and Practice

1. Summary of Recommendation(s).

   The resolution supports the prompt signature, ratification, and implementation of the Hague Conference on the Law Applicable to Securities Held with an Intermediary ("The Hague Convention") by the United States and other countries.

2. Approval by Submitting Entity.

   The Section Council approved the recommendation at its spring meeting on May 10, 2003.

3. Has this or a similar recommendation been submitted to the House or Board previously?

   No.

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

   N/A

5. What urgency exists which requires action at this meeting of the House?

   The U.S. Department of State expects to transmit The Hague Convention to the U.S. Senate in the fall of 2003 with appropriate declarations.

6. Status of Legislation. (If applicable.)

   The Hague Convention requires no Federal implementing legislation or changes to the Uniform Commercial Code or other state law.

7. Cost to the Association. (Both direct and indirect costs.)

   None.

8. Disclosure of Interest. (If applicable.)

   None.

9. Referrals.

Sections of Business Law, Real Property, Probate and Trust Law and Litigation

10. Contact Person. (Prior to the meeting.)

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11. Contact Person. (Who will present the report to the House.)

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EXECUTIVE SUMMARY

1. Summary of the recommendation

   The resolution supports the prompt signature, ratification, and implementation of the Hague Conference on the Law Applicable to Securities Held with an Intermediary ("The Hague Convention") by the United States and other countries. It further supports other similar efforts to simplify and rationalize choice of law issues that will facilitate legitimate cross-border financial transactions and ensure predictability in international commerce.

2. Summary of the issue which the recommendation addresses

   Financial transactions related to or dependent on the movement of securities – payments, derivative deals, repurchase agreements, securities transfers, and the like – are a huge element of international business deals. In the U.S., the mechanics of these transactions are low-risk, thanks to collateralization, a high degree of operational integrity, and a very precise body of governing law (essentially through Articles 8 and 9 of the Uniform Commercial Code). The risk of these transactions, however, increases substantially in the cross-border context, because current international choice-of-law rules are disparate and often unpredictable in application.

3. Explanation of how the proposed recommendation will address the issue

   The Hague Convention is aimed directly at the legal risk noted above. It does not prescribe substantive law for securities intermediaries, but rather provides for the selection of a unique governing law for a transaction, permitting avoidance of unsafe legal regimes and encouraging the adoption of safe legal regimes (such as that provided by the UCC). The primary rule of The Hague Convention for determining the applicable law is to look to the law in force in the jurisdiction expressly agreed in the agreement between the customer and the intermediary governing the securities account, provided that minimal support can be established for the choice of that law.

4. Summary of any minority views or opposition which has been identified

   No opposition has been identified.