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CONVENTION ON THE LAW APPLICABLE TO CERTAIN RIGHTS IN RESPECT OF SECURITIES HELD WITH AN INTERMEDIARY

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Mr. CORKER, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 112–6]

The Committee on Foreign Relations, to which was referred the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (Treaty Doc. 112–6), having considered the same, reports favorably thereon with one declaration, as indicated in the resolution of advice and consent, and recommends that the Senate give its advice and consent to ratification thereof.

CONTENTS

I. PURPOSE

The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "Convention") aims to establish clear rules to resolve a narrow but important problem with respect to determining which country's law applies to certain aspects of a cross-border securities transaction (for example, transactions in which any of the investors or owners, the issuers, the clearing corporation, and the owner's bank or broker are located in different countries).

II. BACKGROUND

In modern capital markets, investment securities are commonly held in electronic form by banks, securities brokers and central clearing depositaries collectively known as "securities intermediaries." Under the laws of many legal systems, when determining what law governs rights in these investment securities, courts apply the law of the place where the paper copies of the securities are physically held or, if the securities are entirely electronic, where they would be held. These determinations are often difficult to make. In the modern economy, electronic securities interests of increasing value move through intermediaries in increasingly high volumes, and frequently cross national borders. The value of trades and collateral transactions in these securities can exceed over $2 trillion per day. Uncertainty as to what law governs the perfection, priority and other interests in the securities arising from these electronic transactions has imposed friction costs on securities transactions, and has limited attempts to reduce credit and liquidity risk exposures.

The Convention provides uniform rules for rapidly determining the law applicable to certain rights in investment securities held through intermediaries. The primary rule of the Convention looks to the law in force in the jurisdiction expressly identified in the agreement between the investor and the intermediary governing the account in which the security is held. The Convention would provide greater legal certainty in this area, thereby reducing legal risk, enhancing efficiency in market transactions and facilitating the global flow of capital. The Convention deals only with choice of law issues and only with securities held with an intermediary and credited to a securities account. It does not include, and has no effect on the substantive law that will be applied once the choice of law determination has been made.

Furthermore, the Convention is limited to international transactions and would apply only in situations where a combination of the account holder, the parties to a disposition of the securities, the securities account or interests therein, the relevant intermediary, or the issuer or issuers of the securities are located in different countries. Finally, account holders and intermediaries are not bound by the Convention's standard choice of law rules if they choose to take affirmative steps to contractually provide for alternative choice of law rules.

The Convention is largely consistent with U.S. law as reflected in Articles 8 and 9 of the Uniform Commercial Code (UCC). The treaty reflects U.S. choice of law principles under UCC Articles 8 and 9. The UCC is not a federal statute but is a state law that has been uniformly adopted by the states in this area. As noted above, the Convention would be limited to transactions involving multiple countries where choice of law rules would be relevant.

The Convention is supported by all relevant U.S. regulatory agencies, including the Department of the Treasury, the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, and the New York Federal Reserve Bank. It is also supported by the National Conference of Commissioners on Uniform State Laws (also known as the "Uniform Law Commission").

The Convention is also supported by securities clearance and settlement entities, including the Depository Trust & Clearing Corporation (the primary U.S. central securities depositary), as well as commercial market interests that include custodian banks, broker-dealers, securities intermediaries, and securities industry associations such as the Securities Industry and Financial Markets Association and the International Swaps and Derivatives Association. The American Bar Association has also adopted a formal resolution recommending U.S. ratification.

A detailed paragraph-by-paragraph analysis of this treaty may be found in the Letter of Submittal from the Secretary of State to the President on this instrument, which is reprinted in full in Treaty Document 112–6. What follows is a brief summary of some key provisions.

III. MAJOR PROVISIONS

As noted above, the Convention is largely consistent with U.S. law, specifically the choice of law rules of Articles 8 and 9 of the Uniform Commercial Code, which are very similar to those of the Convention. Therefore, according to administration testimony before the Foreign Relations Committee, not only would the Convention require minimal adjustment for U.S. investors and financial institutions, it would help globalize the UCC choice of law rules, thereby simplifying the planning for transactions that involve multiple jurisdictions.

The Convention, does, however, differ from the choice of law rules in the UCC in certain minor respects. First and foremost, under Article 4, the Convention has a "Qualifying Office" test while the UCC Articles 8 and 9 choice of law rules do not. The administration observes that this is generally not an obstacle for U.S. banks, brokers or other securities intermediaries, as under current industry practice, they would normally require that the governing law of the account agreement be that of a jurisdiction in which they maintain an office. In response to a question from the Chairman, the administration stated further:

> In fact, the Qualifying Office test arguably may be viewed as a modest improvement to current U.S. law because it requires some minimal connection between the intermediary and the governing law that is chosen. The Convention also sets forth the consequences of a change in the governing law of an agreement. This is a very rare occurrence. Moreover, parties already can amend the governing law in their account agreements under UCC Articles 8 and 9 wholly apart from the Convention.

Satisfying the Qualifying Office test requires more than a mere agency presence. Without a true function in the maintaining of securities accounts, the Qualifying Office test would not be met. Article 4(1) of the Convention requires that the office be "engaged in a business or other regular activity of maintaining securities accounts." Additionally, Article 4(2)(d) makes explicit that the requirement is not satisfied merely because an office "engages solely in representational functions or administrative functions, other than those related to the opening or maintenance of securities ac-

counts, and does not have authority to make any binding decision to enter into any account agreement."

Therefore, the Convention is expected to have very minimal impact on current and future practices in the United States regarding account agreements. The administration has assured the committee that "[i]mplementing and adapting to the Convention's choice of law regime should be relatively easy for U.S. investors and financial institutions, and global market participants should be attracted to U.S. law in view of the clear and workable rules in UCC Articles 8 and 9.

Additional minor differences between the Convention and existing U.S. law include: (a) fall-back choice of law rules that differ slightly from those of UCC Article 8, (b) differing rules on perfection of security interests by filing under two narrow and easily planned-for circumstances, and (c) slight differences from UCC Article 9 in the way the Convention protects interests acquired before an amendment to the governing law set forth in an account agreement.

With respect to perfection of security interests by filing, the administration has informed the committee they do not expect the Convention to disrupt current U.S. industry practices under Article 9 of the UCC, including with respect to the perfection of security interests. UCC Article 9 permits a security interest in intermediated securities to be perfected by either of two principal means: the filing of a financing statement or the secured party's obtaining "control" of the securities. The Convention allows for both of these means of perfection.

In the case of perfection by control, both the Convention and UCC Articles 8 and 9 permit the applicable law to be determined either by the law governing the account agreement, or by a more focused clause in the agreement addressing the issues specified in Article 2(1) of the Convention, including the requirements for perfection. In the case of the Convention, the Qualifying Office test must also be met.

In the case of perfection by filing, the UCC Article 9 choice of law rules provide that the jurisdiction in which the investor is "located" (as determined under UCC Article 9) is the jurisdiction whose substantive law governs perfection by filing. This is the case regardless of the law specified in the account agreement. If perfection is by the filing of a financing statement rather than control, Article 12 of the Convention, dealing with multi-unit countries, then becomes relevant to minimize any disruption of U.S. practices.

Article 12 permits the UCC Articles 8 and 9 choice of law rules to continue to be effective within the United States for purposes of determining the law governing perfection by filing. The administration has provided the committee with the following example:

> [If] the account agreement is governed by New York law, the Convention would generally require that New York law govern issues of perfection. But, if the investor were a Delaware corporation, Article 12 then supplements the Convention's general choice of law rule and permits New York's UCC Articles 8 and 9 choice of law rules to continue to be effective within the United States for purposes of determining the law governing perfection by filing. As a result, applying New York's UCC Article 9 choice of law

rules, Delaware law would still govern perfection by filing as it does in the absence of the Convention. There generally would be no change in U.S. practice for perfection by filing.

The administration notes, however, that there are two limited circumstances in which the Convention would affect the UCC Articles 8 and 9 choice of law rules for perfection by filing:

If the account agreement is governed by the law of a non-UCC-jurisdiction, the availability of perfection by filing would be determined by the law of the non-UCC jurisdiction, not UCC Article 9. For example, if the investor was a Delaware corporation but the account agreement was governed by English law, perfection by filing would be determined under English law. The UCC Article 9 choice of law rules for perfection by filing would not be relevant. We would expect, though, that U.S. intermediaries would typically insist on the law of a UCC jurisdiction to govern their account agreements. Moreover, we would expect global market investors generally to be attracted to choose the law of a state of the United States to govern their account agreements given the clear and workable rules of UCC Articles 8 and 9.

If the law of a UCC jurisdiction governs the account agreement and the investor is located in a non-UCC jurisdiction for purposes of UCC Article 9, the availability of perfection by filing would be determined by the law of the chosen UCC jurisdiction rather than by the law of the non-UCC jurisdiction. For example, if the investor was a company that UCC Article 9 determines to be located in Ontario and the account agreement was governed by New York law, Article 12 of the Convention would not be applicable. That is because New York's UCC Article 8 and 9 choice of law rules do not point to another jurisdiction within the United States; they point to Ontario. Accordingly, under the Convention, New York law, the law chosen in the account agreement, would determine perfection by filing, and a financing statement would need to be filed in New York. That outcome differs from the outcome under the UCC Articles 8 and 9 choice of law rules by which, in the example, perfection by filing would be determined by Ontario law. We believe that this change in the location for the filing of a financing statement can be easily addressed by the secured party investigating the governing law of the account agreement.

IV. Entry Into Force

The treaty will enter into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession. Currently, the Republic of Mauritius and the Swiss Confederation have ratified the treaty. With deposit of its instrument of ratification, the United States would be the third country, bringing the treaty into force among the ratifying countries. Under Article 19 of the treaty, the Convention shall enter into force for both the United

States and the other ratifying countries on the first day of the month following the expiration of three months after the deposit of the U.S. instrument of ratification.

V. IMPLEMENTING LEGISLATION

The executive branch has indicated that the United States currently has all necessary authority to implement the treaty. Accordingly, no new legislation is necessary or is being sought in conjunction with the treaty. The Resolution of Advice and Consent to Ratification includes a Declaration stating that the treaty is self-executing.

VI. COMMITTEE ACTION

The committee held a hearing to consider the treaty on May 19, 2016.[1] The hearing was chaired by Senator Isakson. The committee considered the treaty on June 23, 2016, and ordered the treaty favorably reported by voice vote, with a quorum present and without objection, with the recommendation that the Senate give advice and consent to its ratification, as set forth in this report and the accompanying resolution of advice and consent to ratification.

VII. COMMITTEE RECOMMENDATIONS AND COMMENTS

The committee believes the Convention would provide significant benefits for U.S. investors and financial institutions, notably increased legal certainty in cross-border transactions and a reduction in legal and systemic risk, without having to adapt to a new legal framework and therefore recommends the Senate give its advice and consent to ratification. Further, by providing predictability in these transactions, the Convention would reduce costs and facilitate capital flows. The Convention would not contradict any federal or state laws or common practices in the United States.

The committee believes the Convention will provide a narrow, technical fix to a serious problem in cross-border securities markets in an appropriate and narrowly tailored manner. Because the Convention reflects much of the Uniform Commercial Code, the Convention would in many respects extend current U.S. law and practice to the global financial markets.

The committee has included a proposed declaration in the resolution of advice and consent, which states that the Convention is self-executing. This declaration is consistent with statements made in the Letter of Submittal from the Secretary of State to the President on this instrument. The Senate continues to include statements regarding the self-executing nature of treaties in resolutions of advice and consent in light of the Supreme Court decision, *Medellin* v. *Texas,* 128 S.Ct. 1346 (2008). The committee continues to believe that a clear statement in the resolution is warranted. A further discussion of the committee's views on this matter can be found in Section VIII of Executive Report 110–12.[2]

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[1] To view the published transcript of the May 19, 2016 hearing (S. Hrg. 114–324), *see:* https://www.govinfo.gov/browse/content/pkg/CHRG-114shrg20973/pdf/CHRG-114shrg20973.pdf

[2] To view Exec. Rept. 110–12, *see:* https://www.gpo.gov/fdsys/pkg/CRPT-110erpt12/pdf/CRPT-110erpt12.pdf

VIII. TEXT OF THE RESOLUTION OF ADVICE AND CONSENT TO RATIFICATION

Resolved (two-thirds of the Senators present concurring therein),

SECTION 1. SENATE ADVICE AND CONSENT SUBJECT TO AN UNDERSTANDING AND A DECLARATION.

The Senate advises and consents to the ratification of the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, adopted at The Hague on July 5, 2006, and signed by the United States on that same day (the "Convention") (Treaty Doc. 112–6), subject to the declaration of section 2.

SEC. 2. DECLARATION.

The advice and consent of the Senate under section 1 is subject to the following declaration:

The Treaty is self-executing.

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