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What CLO trustees need to know about the Hague Securities Convention

By Robert J. Coughlin

On April 1, the Hague Securities Convention (the "Convention") took effect in the U.S., creating new rules for determining which country's law will apply to certain types of questions, including perfection of security interests, involving securities accounts held by securities intermediaries when the situation involves a choice between the law of different countries. Although international in nature, the Convention can apply unexpectedly, and is applicable to both new and pre-existing transactions.

The good news for trustees of most U.S.-based CLOs is that not much will change. The Convention honors the express choice of New York law typically found in the transaction documents for a CLO closing in the U.S. with a Cayman Islands SPV issuer and Delaware co-issuer, as long as the securities intermediary (generally, the bank that serves as trustee) has an office somewhere in the United States that meets certain minimal qualifications. Nevertheless, trustees should be aware of some new terms that may be added to CLO documents in response to the Convention.

This article will briefly explain the "primary rule" of the Hague Securities Convention and its application to the typical U.S.-based CLO, and will explain what is meant by the "qualifying office" requirement applicable to the securities intermediary. It will also provide some pointers for trustees when considering new terms proposed for addition to CLO transaction documents to address certain Convention requirements.

What is the Hague Securities Convention?

In a nutshell, the Convention is an international agreement promulgated by the Hague Conference on Private International Law in 2006, which became effective in the U.S. on April 1 of this year. It governs the determination of applicable law (i.e., choice of law) governing certain questions applicable to interests (including security interests) in securities held through a securities intermediary where the situation involves a choice between the law of different countries. As such, it applies only to securities held in an "indirect" holding system through an intermediary, not securities held directly by the trustee or custodian.

How is the Convention, which concerns matters of international law, relevant to a CLO closing in the U.S.?

Close attention is being paid to the Convention because it potentially may be or become applicable to transactions that are not obviously, or not initially, international in character. It also applies to affected transactions whether they closed before or after the April 1, 2017, effective date.

Indeed, there are many ways in which an international element might not be readily apparent or may unexpectedly arise or develop at a later point in time. For example, the Convention could apply in situations where any party to the transaction is located outside the U.S., or where a non-U.S. party (whether a transaction party or a third party) asserts an adverse claim, or where non-U.S. securities are credited to the securities account, or where the securities intermediary holds securities through a non-U.S. sub-intermediary, or where non-U.S. law is specified in another applicable transaction document.

Additional countries are expected to adopt the Convention in the future. In the meantime, its determination of choice-of-law in transactions taking place in the three countries that have adopted it so far (including the United States) will govern whether or not the resulting law determined by the Convention to be applicable in a given transaction is the law of one of those countries.

Why is choice of law important?

Although it does not impose its own substantive legal rules, because the Convention determines which country's law will govern in those situations in which it is applicable, it can potentially preempt the choice-of-law rules in Articles 8 and 9 of the Uniform Commercial Code. As a duly adopted convention under U.S. law, when the Convention is applicable it will prevail over contrary state law. The obvious concern is that in some circumstances it might produce a result in the determination of governing law, especially with regard to the perfection and priority of security interests, which is different from what the transaction parties expected or planned.

How does the Convention affect my CLO?

Here's the good news: despite all the drama, the Convention should not have much of an effect on most (i.e., typical) CLOs based in the U.S. That is not because the Convention might not potentially apply (because it might), but rather because, for what one might regard as a typical U.S. CLO, the Convention should not change the determination of which country's law will govern.

What do we mean by a "typical" U.S.-based CLO? Namely, one with a special purpose (SPV) issuer organized in the Cayman Islands (or other offshore jurisdiction)[1], which owns and grants a security interest in the CLO assets to the CLO trustee as collateral for the Notes issued by the CLO; where the CLO issuer and the CLO trustee, both in its capacity as trustee and as securities intermediary, are parties to an indenture and an account control agreement governing the relevant securities account(s); where the terms of those agreements expressly provide that they are to be governed by the laws of the state of New York[2], and that the "securities intermediary's jurisdiction" for UCC

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[1] The offshore jurisdiction referred to here would be one not having its own system for filing or registering security interests. See footnote 8 below.

[2] See footnote 3 below.

purposes is the state of New York; where there is not another document that constitutes the "account agreement" and says otherwise; and where the CLO trustee acting as securities intermediary has a "qualifying" office (as explained below) located somewhere in the United States (not necessarily in New York).

What does the Convention say exactly?

Without going into detail, the basic rule of the Convention (referred to as the "primary rule," there being other "fallback rules" that will apply in circumstances in which the primary rule does not) can be paraphrased as this:

> If New York law is expressly agreed to as the governing law in the "account agreement," then Articles 8 and 9 of the Uniform Commercial Code as in effect in the state of New York will govern the determination of the perfection and priority of security interests in the securities account(s) governed by the account agreement, as long as the securities intermediary has an office located somewhere in the United States meeting certain minimal requirements (generally referred to as a "qualifying office").[3] In such a case, among other things, the rules under UCC Articles 8 and 9 as in effect in New York for determining where financing statements must be filed in respect of the Cayman Islands issuer (as debtor) for perfection by filing, and permitting the "securities intermediaries jurisdiction" to be designated by agreement of the parties, will be honored.[4]

What is a "qualifying office"?

What is a "qualifying office" for this purpose? As defined in the Convention, the requirements are minimal: for purposes of our example (a "typical" U.S.- based CLO) it means simply an office (other than a place of business that is intended to be merely temporary)[5] located somewhere in the United States, which: (a) alone or together with other offices of the securities intermediary, or with other persons acting for the securities intermediary in the United States or in another jurisdiction (i) effects or monitors entries to securities accounts, (ii) administers payments or corporate actions relating to securities held with the securities intermediary or (iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts, or (b) is identified by an account number, bank code or other specific means of identification as maintaining securities accounts in the applicable country (in this example, the United States).[6]

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[3] The Convention also allows for an alternative formulation in which the parties to the account agreement may opt for the terms of the account agreement to expressly choose the law of a particular jurisdiction, such as the state of New York, to govern all of the issues specified in Article 2(1) of the Convention (which include perfection and priority of security interests), in which case such choice of law will be recognized by the Convention with respect to those issues (and which chosen law may be different from the law that is expressly agreed in the account agreement as the governing law for all other purposes), as long as the securities intermediary has a qualifying office in the relevant jurisdiction, in this example the United States.

[4] See footnote 7 below.

[5] This office also cannot be a place of business of "a person other than the securities intermediary."

[6] An office will not be deemed to satisfy the description in clause (a)(iii) of this paragraph (i.e., an office "otherwise engaged in a business or other regular activity of maintaining securities account[s]") merely because it conducts one of the activities described in Article 4(2) of the Convention, namely: "(a) merely because it is a place where the

(Footnote continued on next page)

A "qualifying office" of the securities intermediary, as described above, can be located in any state in the United States. It should be noted that this office does not need to be located in the same state as the state whose law is adopted as governing law (in our example, New York), and it does not need to be the same office as the one at which the specific securities account(s) governed by the account agreement in question are actually located or administered, or at which the relevant securities are actually held.

Aren't these all just issues for the lawyers?

In a sense, yes. However, requests may be made for the securities intermediary to give or enter into certain new terms in CLO transaction documents or closing instruments to address these new requirements. These may be requested by closing counsel wrestling with the potential applicability of the Convention to the transaction or by counsel issuing UCC perfection opinions.

In this regard, CLO trustees should work closely with their counsel to carefully evaluate and negotiate any requested certifications, representations or covenants, and are cautioned in particular to avoid representations or certifications that are overbroad, or which are phrased as or include conclusions of law or seek to impose or shift affirmative obligations to the trustee or securities intermediary. The Convention requirements are new and a great deal of uncertainty still surrounds their meaning and application.

What new terms are being added concerning the Convention?

As one might expect, terms are being added to confirm that the securities intermediary has a "qualifying office" as described in Convention Article 4(1) located in the United States. This is meant to provide a basis for counsel to conclude that the "primary rule" of the Convention will apply and will recognize the express adoption of New York law contained in the applicable transaction documents.

Some inquiry also may be made relevant to the "account agreement" for purposes of the Convention. The Convention primary rule recognizes the law "expressly agreed in the account agreement" (as further provided in the Convention), but leaves the "account agreement" fairly loosely defined.[7] Since the "qualifying office" requirement under Article 4(1) must be met at the "time of the agreement," consideration may also be given to the possibility of reapplication if and at the time the account agreement were to be amended to change or expressly reconfirm the governing law provision.

technology supporting the bookkeeping or data processing for securities accounts is located; (b) merely because it is a place where call centres for communication with account holders are located or operated; (c) merely because it is a place where the mailing relating to securities accounts is organised or files or archives are located; or (d) if it engages solely in representational functions or administrative functions, other than those related to the opening or maintenance of securities accounts, and does not have authority to make any binding decision to enter into any account agreement."

[7] It is fundamentally described as the agreement between the account holder and the intermediary governing the securities account and their respective rights duties in relation to securities that are or may become credited to the securities account maintained by the intermediary. The definition does not require that the agreement fulfill any formal requirements and, with respect to Article 4(1), the description allows for the agreement to be oral or in writing (or partly oral and partly in writing), or one which may incorporate in whole or in part rules or procedures of the intermediary, and which, if in writing, may consist of one or more documents.

The reader should keep in mind that the discussion above concerns only with what we describe above as a "typical" U.S.-based CLO. The specifics of each situation need to be carefully examined, both as to factual circumstances and the terms of the governing documents. Material differences can yield different results.[8] Moreover, the reach of the Convention's choice of law rules goes well beyond issues of perfection and priority of security interests, and there are nuances in its application that may need to be taken into account in a given circumstance beyond what is discussed here.

The Corporate Trust Team at Nixon Peabody addresses these issues on behalf of its trustee and securities intermediary clients in ways that maintain appropriate protection without impeding transaction flow or timeliness.

If you have any questions concerning this article or application of the Hague Convention, please contact your regular Nixon Peabody attorney or:

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[8] For example, the Convention accepts the perfection by filing rules under the choice-of-law provisions of UCC Articles 8 and 9 within the United States only so long as the choice-of-law rules of the state determined by the Convention to be applicable will cause the law of another U.S. state to apply. If the CLO issuer granting the security interest were to be a registered organization organized in Ontario, Canada, the analysis and choice-of-law result under the Convention for filing by perfection would be different (because the law of Ontario, unlike the Cayman Islands, provides a system for registration of security interests, producing different results under both the UCC and the Convention).