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Analysis of regulation 11.2 of the Regulations on Prospecting and Exploration for Polymetallic Nodules and Polymetallic Sulphides in the Area

Note by the Secretariat

I. Background

1. In its decision ISBA/17/C/20 of 21 July 2011, the Council of the International Seabed Authority requested the Legal and Technical Commission to analyse regulation 11.2 of the Regulations on Prospecting and Exploration for Polymetallic Nodules in the Area (the Nodules Regulations) and regulation 11.2 of the Regulations on Prospecting and Exploration for Polymetallic Sulphides in the Area (the Sulphides Regulations), and to report thereon to the Council for its consideration.[1]

2. The present note is intended to assist the Commission by providing a preliminary analysis of the relevant provisions.

II. Regulation 11

3. Regulation 11 concerns the certificate of sponsorship. The purpose of this provision is to implement the provisions of the United Nations Convention on the Law of the Sea and the 1994 Agreement relating to the implementation of Part XI of the Convention, concerning the requirement of sponsorship by States parties. Article 4 of annex III to the Convention stipulates that applicants must meet the nationality or control and sponsorship requirements of article 153, paragraph 2(b), and follow the procedures and meet the qualification standards set forth in the rules, regulations

[1] It may be noted that, subsequent to the decision of the Council, the Council adopted, and the Assembly of the International Seabed Authority approved, the Regulations on Prospecting and Exploration for Cobalt-rich Ferromanganese Crusts in the Area (ISBA/18/A/11, annex), which contain an identical provision. The contents of the present note are therefore equally relevant to the Crusts Regulations.

and procedures of the Authority. Article 153(2)(b) of the Convention stipulates that natural or juridical persons are qualified to apply as long as they possess the nationality of States parties or are effectively controlled by them or their nationals, and are sponsored by such States.

4. Article 4(3) of annex III to the Convention stipulates that:

> Each applicant shall be sponsored by the State Party of which it is a national unless the applicant has more than one nationality, as in the case of a partnership or consortium of entities from several States, in which event all States Parties involved shall sponsor the application, or unless the applicant is effectively controlled by another State Party or its nationals, in which event both States Parties shall sponsor the application. The criteria and procedures for implementation of the sponsorship requirements shall be set forth in the rules, regulations and procedures of the Authority.

5. Paragraphs 1 and 2 of regulation 11, in all three sets of Regulations, provide as follows:

> 1. Each application by a State enterprise or one of the entities referred to in regulation 9 (b) shall be accompanied by a certificate of sponsorship issued by the State of which it is a national or by which or by whose nationals it is effectively controlled. If the applicant has more than one nationality, as in the case of a partnership or consortium of entities from more than one State, each State involved shall issue a certificate of sponsorship.
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> 2. Where the applicant has the nationality of one State but is effectively controlled by another State or its nationals, each State involved shall issue a certificate of sponsorship.

III. Sponsorship and effective control

6. Thus, for natural and juridical persons to be eligible to carry out activities in the Area, they must satisfy two requirements. The first is that they must either be nationals of a State party or effectively controlled by it or its nationals. The second is that they must be sponsored by one or more States parties to the Convention. If a State that is different from the State of nationality or its nationals exercises effective control, or if the applicant has more than one nationality, the sponsorship of that State or States is also required.

7. The decision to sponsor an entity that is otherwise qualified is left to the discretion of the State party. In the words of the Seabed Disputes Chamber, because "the Convention does not consider the links of nationality and effective control sufficient to obtain the result that the contractor conforms with the Convention and related instruments, it requires a specific act emanating from the will of the State or States of nationality and of effective control. Such act consists in the decision to sponsor."[2] This act, which evidences sponsorship, is a certificate which shall contain "a statement that the applicant [for a plan of work for exploration] is: (i) a national of the sponsoring State; or (ii) subject to the effective control of the

[2] Seabed Disputes Chamber, *Responsibilities and obligations of States sponsoring persons and entities with respect to activities in the Area, case No. 17, Advisory Opinion*, 1 February 2011, para. 78.

sponsoring State or its nationals" (regulation 11, para. 3(c)). This also implies that the onus is on the sponsoring State to ensure that those criteria are satisfied before taking the decision to sponsor an entity which otherwise possesses the necessary qualifications.

8. The requirement of sponsorship by a State party is not differentiated between developing and developed States:

> [E]quality of treatment between developing and developed sponsoring States is consistent with the need to prevent commercial enterprises based in developed States from setting up companies in developing States, acquiring their nationality and obtaining their sponsorship in the hope of being subjected to less burdensome regulations and controls. The spread of sponsoring States "of convenience" would jeopardize uniform application of the highest standards of protection of the marine environment, the safe development of activities in the Area and the protection of the common heritage of mankind.[3]

IV. The meaning of "effective control"

9. In an attempt to define the effective control exercised by a sponsoring State, it is useful to refer to the *travaux préparatoires* of the relevant provisions in the Convention, to recall the context and purpose of the effective control by a sponsoring State and to briefly refer to other contexts and purposes where the expression "effective control" is used.

Travaux préparatoires, context and purpose of effective control by a sponsoring State

10. The terms "effective control" and "effectively controlled" are not defined in any of the provisions quoted above. Nor are they defined in the *travaux préparatoires* of the Convention.[4] For the most part, discussions on article 153 related to the question of the extent of control to be exercised by the Authority over activities in the Area. Issues relating to the qualification standards of applicants were addressed only after 1977, after the "mixed system" of access by States, natural or juridical persons and the Enterprise had been agreed upon. Once that had been agreed, it was clear that it would be necessary for the relevant applicant both to be sponsored by a State and to be in a position to provide the Authority with appropriate guarantees as to compliance. However, it was not until the Informal Composite Negotiating Text (ICNT/Rev.2 (1980)) that the issue of an applicant having the nationality of more than one State or where an applicant was effectively controlled by another State or its nationals was introduced. It appears that the main concern at the time was to deal with the case of the consortia of the United States of America, which were all joint venture operations. The official records of the third United Nations Conference on the Law of the Sea give very little insight into this issue, although it was noted in the report of the coordinators of the working group of 21 to the First Committee at the ninth session, held in August 1980 (A/CONF.62/C.1/L.28 and Add.1), that:

[3] Ibid., para. 159.

[4] S. N. Nandan, M. W. Lodge and S. Rosenne, eds, *United Nations Convention on the Law of the Sea 1982 – A Commentary*, Vol. VI, (The Hague: Martinus Nijhoff, 2002).

> Paragraph 2 of article 4 on sponsorship of applicants presented problems for the delegations of some developed countries. For them, the provision related to the effective control of an application by a State party gave rise to problems of implementation. For other delegations the maintenance of the rule contained in this paragraph was essential. After prolonged discussions we finally found a solution that I hope is acceptable to all. I decided to keep the rule of the multiple sponsorship as it appears in document A/CONF.62/WP.10/Rev.2 and add a new sentence establishing that the "criteria and procedures for implementation of the sponsorship requirements shall be set forth in the rules, regulations and procedures of the Authority".[5]

11. Some guidance as to the meaning of "effective control" is provided by the material that an applicant which is a juridical person is required to include in the application. It must identify its place of registration and its principal place of business/domicile, and attach a copy of its certificate of registration (annex II to each set of Regulations). That information and certificate of registration, together with the certificate of sponsorship, also enable the Commission to ascertain that an applicant meets the sponsorship requirements under regulation 11.

12. The nature and scope of the obligations and liability of sponsoring States provide essential insights as to the context and purpose of the effective control test. This was at the core of the advisory opinion rendered by the Seabed Disputes Chamber in 2011. The Convention requires a sponsoring State to adopt laws and regulations and to take administrative measures which are, within the framework of its legal system, reasonably appropriate for securing compliance by persons under its jurisdiction and thence effective regulatory control so that it may be exempted from liability for damage caused by any failure of a contractor under its sponsorship to comply with its obligations. The purpose of sponsoring requirements is to ensure that obligations that are binding on States parties are fulfilled by entities that are subjects of domestic legal systems. As a result, if a sponsoring State finds it useful to elaborate on the conditions to grant its sponsorship, it has the competence to address this question within its domestic legal framework. The Seabed Disputes Chamber expressed it clearly:

> The sponsoring State may find it necessary, depending upon its legal system, to include in its domestic law provisions that are necessary for implementing its obligations under the Convention. These provisions may concern, inter alia, financial viability and technical capacity of sponsored contractors, conditions for issuing a certificate of sponsorship and penalties for non-compliance by such contractors.[6]

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[5] The provision as it then appeared (annex III, article 4(2) of document ICNT/Rev.2 (A/CONF.62/WP.10/Rev.2)), read as follows: "Sponsorship by the State party of which the applicant is a national shall be sufficient unless the applicant has more than one nationality, as in the case of a partnership or consortium of entities from several States, in which event all States parties involved shall sponsor the application, or unless the applicant is effectively controlled by another State party or its nationals, in which event both States parties shall sponsor the application."

[6] Seabed Disputes Chamber, *case No. 17*, para. 234. More details are provided in paras. 227-241 on the content of open-ended measures which are policy matters made by the sponsoring State (para. 227).

Other legal contexts and purposes referring to the exercise by a State of effective control

13. "Effective control" is a term that occurs rather frequently in the context of multinational enterprises, joint ventures, mergers, competition and monopolies. For example, in the context of defining what constitutes an arm's length transaction[7] between related corporate entities in domestic legal systems, Indian company law considers a 26 per cent ownership of the shares of the associated company as equivalent to effective control.[8] Japan will apply the rule when the control is to the extent of 50 per cent.[9] Spain considers that 25 per cent ownership is sufficient to lead to control.[10] British company law defines control of a company to mean the capacity of a person by means of shareholding or the effective possession of voting power conferred by the articles of association.[11] French law takes into account de facto control also.[12] This small sample shows that the definition varies in municipal laws.

14. The expressions "effective control" and "effectively controlled" are also found in the context of nationality of ships flying the flag of the State whose nationality it has. Article 91 of the Convention requires that there exist a "genuine link" between a State and a vessel flying its flag. In terms of establishing a genuine link between a vessel and its flag State, it is the act of registration that conveys nationality to a ship and provides the basis for jurisdiction over the vessel, irrespective of ownership or financial interest in the vessel or its operations.[13] It is left to States to set in their domestic legal systems the conditions for the grant of its nationality to ships, for the registration of ships in its territory and for the right to fly its flag.

15. Incorporation and registration are also conditions that apply for the purposes of exercising diplomatic protection over a corporation by the State of incorporation and registration. In the *Barcelona Traction* case, the International Court of Justice held that international law "attributes the right of diplomatic protection of a corporate entity to the State under the laws of which it is incorporated and in whose territory it has its registered office".[14] Two conditions are set for the acquisition of nationality by a corporation for the purposes of diplomatic protection: incorporation and the presence of the registered office of the company in the State of

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[7] The arm's length principle, despite its informal-sounding name, is found in article 9 of the Model Tax Convention on Income and on Capital, of the Organization for Economic Cooperation and Development (OECD) and is the framework for bilateral treaties between OECD countries, and between many non-OECD Governments as well. This valuation principle is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest. (*Annual Report on the OECD Guidelines for Multinational Enterprises 2006*: *Conducting Business in Weak Governance Zones* (Paris, OECD, 2006)).

[8] Section 92A of the 1961 Indian Income Tax Act to cover direct/indirect participation in the management, control or capital of an enterprise by another enterprise.

[9] Article 66-4 of the Special Taxation Measures Law and article 39-12 of the Cabinet Order on the Special Taxation Measures Law.

[10] Available online at www.oecd.org/tax/transfer-pricing/Spain_TPcountryprofile_Sept2012.pdf.

[11] Taxation (International and Other Provisions) Act 2010, sects. 147 and 148.

[12] General Tax Code (Code général des impôts), sect. 57.

[13] See, e.g. ITLOS, cases Nos. 1 and 2, *M/V "Saiga" (Saint Vincent and the Grenadines v. Guinea)*, and case No. 8, *"Grand Prince" (Belize v. France)*.

[14] *Barcelona Traction, Light and Power Company, Limited (Belgium v. Spain), I.C.J. reports* 1970, p. 42, para. 70.

incorporation; nationality of a corporation is not acquired on the ground that the majority of shareholders are nationals of that State. The International Court also suggested that in addition to incorporation and a registered office, there was a need for some "close and permanent connection" between the State exercising diplomatic protection and the corporation.[15] In that case the connection was established by the facts that the corporation maintained its registered office, its account and its share registers in its State of incorporation (Canada); its board meetings were held in Canada; and the company was listed in the records of the Canadian tax administration.

16. However, in the *Barcelona Traction* case, the Court did not have to address the situation in which a company was incorporated in one State but had a "close and permanent connection" with another State. Article 9 of the 2006 draft articles on diplomatic protection of the International Law Commission addresses this situation:[16]

> For the purposes of the diplomatic protection of a corporation, the State of nationality means the State under whose law the corporation was incorporated. However, when the corporation is controlled by nationals of another State or States and has no substantial business activities in the State of incorporation, and the seat of management and the financial control of the corporation are both located in another State, that State shall be regarded as the State of nationality (A/61/10, para. 49, art. 9).

In the first instance the State in which a corporation is incorporated is the State of nationality entitled to exercise diplomatic protection. When, however, the circumstances indicate that the corporation has a closer connection with another State, a State in which the seat of management and financial control are situated, that State is the State of nationality entitled to exercise the diplomatic protection. Cumulative conditions must, however, be fulfilled. First, the corporation must be controlled by nationals of another State. Secondly, it must have no substantial business activities in the State of incorporation. Lastly, both the seat of management and the financial control of the corporation must be located in another State. Only when these cumulative conditions are met does the State in which the corporation has its seat of management and in which it is financially controlled qualify as the State of nationality for the purposes of diplomatic protection.

17. The foregoing solution exists for the purposes of diplomatic protection. However, it is doubtful that it can be transposed for purposes of a sponsoring State being required to exercise its effective control over a sponsored entity that would not be registered into that sponsoring State. For example, that situation may arise

[15] Ibid, para. 71.

[16] At its fifty-eighth session, the International Law Commission adopted the draft articles on diplomatic protection, on second reading, together with commentaries. In accordance with article 23 of its statute, the Commission decided to recommend to the General Assembly the elaboration of a convention on the basis of the draft articles. By its resolution 68/113 of 16 December 2013, the Assembly decided to include in the provisional agenda of its seventy-first session (2016) the item entitled "Diplomatic protection" and, within the framework of a working group of the Sixth Committee, in the light of the written comments of Governments, as well as views expressed in the debates held at the sixty-second, sixty-fifth and sixty-eighth sessions of the Assembly, to continue to examine the question of a convention on diplomatic protection, or any other appropriate action, on the basis of those articles and to also identify any difference of opinion on the articles.

where a subsidiary company is registered in a sponsoring State but depends financially and technically on a parent company which is not registered in the sponsoring State. Given that the two companies are separate legal entities, if the veil cannot be lifted, the sponsoring State will not be in a position to exercise its effective control over the parent company and may not be able to comply with its due diligence obligations and direct obligations as a sponsoring State by virtue of the Convention and its related instruments.

18. Indeed, in international law, the need to distinguish between legal structure and actual control may become crucial when attempts are made to affix responsibility for corporate actions. In the case of multinational enterprises each transaction between members of the enterprise or between a member of the enterprise and an outsider may be subject to regulation by more than one State. In such circumstances it may become necessary to pierce the veil of separate incorporation between a subsidiary and the parent company, particularly for the purposes of determining either jurisdiction or liability. Even then, it is apparent that the standards for lifting the corporate veil in relation to jurisdiction and liability differ significantly from State to State. Furthermore, jurisdiction can exist where liability does not. The question is one of fact to be determined from the circumstances and is addressed in municipal laws.[17]

19. Effective control and ownership are also essential criteria in international law relating to civil aviation. Under the Convention on International Civil Aviation of 7 December 1944 (the Chicago Convention) and related agreements, the operation of scheduled international air services is subject to authorization between States. In particular, contracting States reserve the right to withhold permission where it is not satisfied that “substantial ownership and effective control” of an airport air transport enterprise is vested in nationals of the requesting State. The relevant agreements, however, are generally silent as to the criteria for determining substantial ownership and effective control. While most countries have specified percentages of maximum foreign ownership or minimal national ownership, the literature suggests that in practice ownership is merely a preliminary condition, with effective control being the predominant condition. Effective control in this context is a de facto condition that must be judged according to the precise effects of every case.

20. The problem with using civil aviation as a comparator is that the imposition of ownership and control tests is widely perceived to be archaic and a major impediment to the efficient liberalization of global air services. The emerging trend is towards a test of effective control that emphasizes “regulatory control” over

[17] Among the factors that are relevant are the following:
- The parent and the subsidiary have common stock ownership, common directors or officers, or common business departments
- The parent and the subsidiary file consolidated financial statements and tax returns
- The parent finances the subsidiary
- The parent caused the incorporation of the subsidiary
- The subsidiary operates with grossly inadequate capital
- The parent pays the salaries and other expenses of the subsidiary
- The subsidiary receives no business except that given to it by the parent
- The parent uses the subsidiary’s property as its own
- The daily operations of the two corporations are not kept separate
- The subsidiary does not observe the basic corporate formalities, such as keeping separate books and records and holding shareholder and board meetings.

ownership and investment criteria. For example, recent multilateral agreements, including that between the United States of America and Asia-Pacific Economic Cooperation, and a proposed United States-European Union umbrella agreement, propose significant loosening of the substantial ownership requirement and refinement of the effective control test to create a test that emphasizes place of incorporation, jurisdiction of incorporation, principal place of business and regulatory control by the aviation authorities of the relevant State party as the relevant criteria for determining whether control is adequate.[18] The International Civil Aviation Organization itself, at the Worldwide Air Transport Conference held in 2003, proposed using the tests of principal place of business and effective regulatory control instead of substantial ownership and effective control.

V. Summary and recommendations

21. From this brief overview of various contexts and purposes for the exercise of effective control, it is clear that there is no single definition of the expression "effective control" and the meaning attributed to it varies considerably depending upon the context and the purpose for which the test of effective control is being applied.[19] The second conclusion is that conditions and standards which define effective control fall under the competence of the State that exercises it. International law does not define further the meaning of effective control, which is left to municipal law if the State finds it necessary to elaborate on conditions and standards to exercise its regulatory control. The third conclusion is that the law and practice relating to both flagging of vessels and civil aviation as well as the Part XI regime follows the same approach. This emphasizes the fact of incorporation/registration and the grant of nationality (i.e. regulatory control) as the critical, or dominant, factor, notwithstanding the practical realities as to control over policy, capital, finance and management.

22. In ascertaining that an applicant is qualified, the Commission must satisfy itself that the sponsorship requirements under article 153 of the Convention are met in accordance with annex III to the Convention and with the Regulations. At least in relation to entities incorporated in or having the nationality of a sponsoring State, the act of incorporation, or the conferring of nationality, combined with the undertakings given as a sponsoring State, seem to be sufficient to establish "effective control" for the purposes of meeting the sponsorship requirements. Even complete commercial and financial domination of a subsidiary company by a parent company is not necessarily enough by itself to found sponsorship jurisdiction as long as formal separation between the two entities is maintained.

23. In light of those preliminary views, it is open to question how far the rules, regulations and procedures of the Authority should go beyond the certificate of

[18] See www.ecipe.org/media/publication_pdfs/GelosoGrosso_Liberalising_Air_passenger_122008.pdf.

[19] Different meanings also apply in different legal systems. OECD, for example, states that: "Control over enterprises is generally viewed to be exercised when an individual or group of investors hold more than 50 per cent of the common voting stock of the enterprise or firm. However, 'effective control' may be exercised when the investor(s) holds a large block of voting stock even when it is less than 50 per cent but the remaining shares are widely held by many smaller investors. Control of enterprises may also be exercised through interlocking directorates and inter-corporate ownership links between firms as in the case of conglomerates." (*Glossary of Industrial Organisation Economics and Competition Law* (Paris, OECD 1993), p. 31).

sponsorship. It may be that criteria and procedures for meeting sponsoring requirements are more appropriately set forth in the laws, regulations and administrative measures which a sponsoring State is required to adopt under article 4, paragraph 4, of annex III to the Convention, bearing also in mind that the decision to sponsor belongs to the State.

24. The Commission is invited to consider regulation 11.2 on the basis of the foregoing preliminary analysis and to report thereon to the Council, as appropriate.