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on

The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary

Before the Committee on Foreign Relations

United States Senate

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Chairman Isakson, Ranking Member Shaheen, and Members of the Committee, I appreciate this opportunity to testify today in support of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary ("the Convention").

The Convention was adopted by the Hague Conference on Private International Law on July 5, 2006, and it was signed by the United States and Switzerland that same day. The Convention will enter into force after the deposit of the third instrument of ratification. Switzerland and Mauritius have ratified the Convention. Many countries are looking to the United States, upon whose law the Convention largely was based, to become a party before they take action.

In brief, the rules in the Convention provide a narrow, technical fix to a serious problem in cross-border securities markets that has already been fixed domestically through adoption by all U.S. states of Articles 8 and 9 of the Uniform Commercial Code (UCC). The Convention, if widely adopted, would basically extend current U.S. law and practice to the global financial markets.

In particular, the rules in the Convention solve the current quandary of determining which country's law applies to certain aspects of a cross-border transaction in which the investor or owner, the issuer, the clearing corporation, and the owner's bank or broker may be located in different countries. As a result, the Convention (1) reduces the legal and systemic risks in cross-border investment securities transactions; (2) reduces costs; and (3) facilitates capital flows.

My statement will consist of three parts. First, I will provide some background on the Convention explaining the nature of the problem that the Convention was designed to address. Second, I will explain how the Convention addresses the problem and briefly run through its basic provisions. Third, I will indicate the Convention's relation to domestic law and its importance to U.S. banks, brokers and others.

I. Background – the Nature of the Problem

Historically, owners of securities had a direct relationship with the issuer. Investors or owners would either have physical possession of the securities certificates, or be recorded on the issuer's share registry. The location of the certificate or registry was readily identifiable.

Over time, however, financial markets have expanded and moved to a system of securities clearance, settlement, and ownership where the ownership information is held electronically and indirectly as a book entry. This so-called "indirect system" consists of one or more tiers of intermediaries between the issuer and the owner. These so-called "intermediated" securities are maintained through clearing corporations (or central securities depositories) for the accounts of banks, brokers, and other financial institutions which in turn maintain accounts for their customers (the beneficial owners of the securities). The owners do not appear on any registry maintained by the issuer, nor do they have actual possession of certificates.

In the movement towards book-entry systems, it has become increasingly difficult for financial market participants to determine which country's law would apply to transactions involving securities held through these systems that involve different countries. (For example, suppose that a New York broker holds stock issued by Japanese and Singapore companies for a South American customer.) Also, these cross-border transactions take place very quickly and in huge volumes.

Many countries' legal systems have not kept up with the book-entry system, and their rules remain different than those in the United States. This problem affects U.S. financial institutions every day, and increases legal uncertainty and raises costs associated with the often-complicated determination of which country's law may apply.

That is why the Uniform Law Commission (ULC) and the American Law Institute in 1994 addressed this problem domestically in revising the UCC. The rules in the Convention reflect the modern finance law of the United States in Articles 8 and 9 of the UCC, adopted by all U.S. states and the District of Columbia. The Convention would bring this modern approach to the global markets.

II. The Proposed Solution

I turn now to the solution to this problem that is provided by the Convention.

The Convention's focus is important but narrow. It deals with intermediated securities but not securities directly held by the investor from the issuer. The Convention does not prescribe substantive law for securities intermediaries, and it has no effect on regulatory law. The Convention simply selects a governing law for certain issues related to an intermediated securities transaction, thereby

providing legal certainty on the law applicable to those issues, and avoiding the need to comply with the laws of multiple jurisdictions for the same transaction.

The issues covered by the Convention include the legal rights and obligations of the intermediary; the legal nature and effect of a disposition of the investor's interest in the securities by the investor's bank or broker, to a buyer or a secured lender; and how priority conflicts among the buyer, the secured party and a judgment lien creditor are resolved if there are conflicting claims to the securities.

The primary rule of the Convention for determining the applicable law is to look to the law of the jurisdiction whose law governs the account agreement between the customer and the intermediary. Virtually all book-entry systems are covered by an account agreement, and the very large majority of those agreements specify a governing law.

Under the Convention, some minimal nexus must be established for the choice of that law, such as an office (a place of business) of the intermediary that performs certain functions in the chosen jurisdiction dealing with securities, even if those functions are unrelated to any particular securities account. This is generally not an issue for U.S. banks or brokers. They would normally require that the governing law of the account agreement be that of a jurisdiction in which they maintain an office.

If the applicable law cannot be determined pursuant to an agreement between the customer and the intermediary, certain fallback provisions in the Convention would ultimately apply the law of the jurisdiction in which the intermediary is organized.

III. Relation to U.S. Domestic Law

Turning now to the third part of my presentation, the Convention is consistent with, and was largely based on, U.S. law.

The Convention generally follows the approach to choice of law for the indirect holding system contained in Article 8 of the UCC. Article 8 was specifically revised in 1994 to reflect the increasing use of securities accounts without physically identifiable securities or issuer share registries. In particular, UCC Article 8 permits the intermediary and the customer to determine the law that governs the transaction by express agreement.

As previously noted, the Convention has no effect on regulatory law or the jurisdictional scope or mandate of any banking, securities, or other regulators. Federal law does not cover these types of commercial transactional matters, so there is no federal law that would be displaced. In addition, the Convention would not affect any other legal rules or contractual provisions that are not specified in the Convention.

UCC Articles 8 and 9 will continue to cover any issues not covered by the Convention and issues related to securities held directly by the investor or owner.

There are some minor differences between the Convention and UCC Articles 8 and 9, relating to perfection by filing, and regarding the consequences of a change in the governing law of the agreement (which would be a rare occurrence). Also, UCC Article 8, while permitting the intermediary and the customer to select the applicable law, does not contain a "qualifying office" rule.

None of these differences are significant, and none of the interested U.S. industry associations or the ULC has indicated any difficulty with these differences. These minor differences are not expected to create any difficulties for U.S. practices under UCC Articles 8 and 9.

The Administration has proposed that the Convention be self-executing. No federal or state legislation would be required to implement the Convention. This method of domestic implementation was supported by the ULC. There is no need to craft federal legislation that would intersect with Articles 8 and 9 of the UCC since the terms of the Convention itself would do that adequately.

Finally, the Convention does not permit reservations, and the Administration has not proposed any understandings or declarations.

IV. Benefits of U.S. Ratification

My last and perhaps most important point is that I hope the Senate will appreciate the many benefits of U.S. ratification of the Convention.

The Convention would contribute to the 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 would reduce the costs of cross-border securities transactions for securities investors, market actors, and custodians. As a result, the Convention would facilitate the flow of capital to both developed and emerging markets.

In addition to the aforementioned benefits to the United States, U.S. banks and brokers would benefit in particular because the Convention sets forth modern rules with which U.S. intermediaries already are familiar and are generally applying. Further, U.S. investors would benefit. For example, many Americans have pension funds or 401(k) accounts, and these pension funds have large holdings in securities that are managed under the book-entry systems I have described. Widespread adoption of the Convention would enhance harmonization and lower the costs of cross-border transactions involving these funds.

It is therefore not surprising that industry trade associations such as the International Swaps and Derivatives Association, the Securities Industry and Financial Markets Association, the Association of Global Custodians, and the Trade Association for the Emerging Markets (EMTA) have written to this Committee indicating their support for U.S. ratification. Also, notably, the President of the ULC sent a letter to this Committee supporting U.S. ratification of the Convention.

In view of the successful development of UCC Articles 8 and 9 in the United States, and given this country's significant role in cross-border securities transactions, other countries are looking to U.S. leadership on the Convention.

If the United States becomes a party, we expect that many other countries, including Canada, as well as countries in Asia, South America, and Africa, will be encouraged to join the Convention and adopt the same rules on choice of law for cross-border securities transactions. As other countries proceed to adopt the Convention, legal certainty will continue to increase for all securities transactions, including those carried out by banks, brokers and other market participants in the United States.