HAGUE SECURITIES CONVENTION

Testimony of Edwin E. Smith
Before the Senate Foreign Relations Committee

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Chairman Isakson, Ranking Member Shaheen, and the members of the committee, thank you for the opportunity to testify before you today on the Hague Securities Convention. I am a partner at the law firm of Morgan, Lewis and Bockius LLP, where I regularly represent clients in cross-border transactions and insolvencies, including transactions that would be covered by the Convention. I am also a Uniform Law Commissioner and have participated in the drafting of revisions to the Uniform Commercial Code. I appreciate the opportunity to appear today to express my support for the Hague Securities Convention.

The Hague Securities Convention, formerly known as the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "Convention"), was promulgated in 2006 by the Hague Conference on Private International Law and has been adopted thus far by Mauritius and Switzerland. The Convention has been signed by the United States but has not been ratified. The Convention requires that at least three countries adopt the Convention for the Convention to go into effect. If the United States were to ratify the Convention, the Convention would then go into effect among the adopting countries, and many more countries would likely follow the lead of the United States in adopting the Convention.

The Convention addresses certain important conflict of laws issues that arise under current law when securities are held with a bank, broker or clearing corporation through the so-called "indirect holding system." The uncertainty under current law on these issues creates significant risks for securities customers, banks, brokers, clearing corporations and third party lenders. The Convention, if widely adopted, would resolve these issues. Ratification of the Convention by the United States is supported by the American Bar Association, the Association of Global Custodians, the International Swaps and Derivatives Association, the Securities Industry and Financial Markets Association and the Uniform Law Commission. The United States should ratify the Convention.

I will first explain why the United States should ratify the Convention and then briefly describe the indirect holding system, explain the conflict of laws problems that arise under current law and describe how the Convention will solve those problems without disrupting current practices in the United States

The Indirect Holding System

In the indirect holding system, the registered owner of securities of an issuer is typically a clearing corporation, such as Depository Trust Company, Clearstream or Euroclear. The

clearing corporation maintains accounts that reflect that the interests in the securities are for the benefit of a bank or broker. The ultimate beneficial owner of the securities may be a customer of the bank or broker. So, if a retail securities customer says "I own IBM securities," what the customer really means in the indirect holding system is that the customer has a right to the securities against the customer's bank or broker and that the bank or broker has a right to the securities against the clearing corporation.

The Conflict of Laws Problems under Current Law

The Problems in General

The cross-border holding of securities in the indirect holding system raises conflict of laws issues that are not easily resolved under the current law. Securities may be issued by a company located in Country A to a clearing corporation located in Country B which holds the securities for a bank or broker in Country C and that in turn credits interests in the securities to the account at the bank or broker of a customer located in Country D. A third party lender to the customer, relying on recourse to the securities in extending credit to the customer, may even be located in Country E. Current law is very unclear as to which country's laws govern the following issues:

- The disposition of the customer's interest in the securities by the bank or broker to a buyer of the securities with or without the customer's consent;
- The perfection steps that need to be taken for a customer to grant a security interest in the customer's interest in the securities to the bank or broker or to a third party lender to the customer;
- The right of a judgment creditor of the customer to attach or levy on the interest of the customer in the securities;
- Whether any interest in the securities obtained by the buyer, secured party or judgment lien creditor extends to dividends and other distributions on the securities;
- How the priority conflict among the buyer, the secured party and the judgment lien creditor is resolved if they all claim an interest in the securities; and
- How any transfer of an interest in the securities is characterized for purposes of determining whether the transfer is a sale or merely creates a security interest that secures an obligation.

Under current law, the resolution any of these conflict of laws issues - i.e., determining which jurisdiction's substantive law applies to the issue - may depend upon where any litigation raising the issue is brought. The court in the country in which the litigation is brought would apply the conflict of laws rules of that country. Those rules might point to the substantive law of that country or to the substantive law of another country to resolve the issue. However, if litigation were brought in a court of another country, the court in that other country may, using

its conflict of laws rules, apply its own substantive law or the substantive law of an entirely different country to resolve the issue.

An Example

To illustrate, let's assume that a bank located in New York acts as a securities custodian. The bank custodian credits to an account of its customer an interest in securities issued by an issuer in Country X and held by a clearing corporation for the account of the custodian. A third party lender extends credit to the customer, obtains a security interest in the customer's interest in the securities under New York law to secure the repayment of the credit and takes all appropriate steps under New York law to perfect the security interest. Later, a creditor of the customer obtains a judgment against the customer and seeks a judgment lien on the customer's interest in the securities.

Under New York's conflict of laws rules, so long as the custody agreement designates New York as the "securities intermediary's jurisdiction" or, absent that designation, is governed by New York law, New York substantive law will determine how the creditor obtains the judgment lien and how the priority conflict between the lender as secured party and the judgment lien creditor is resolved. Applying New York substantive law, the attachment of the lien must be made by service of process on the custodian. And, under New York substantive law, the lender, holding a perfected security interest in the securities, prevails over the judgment lien creditor.

However, if the creditor brings a lawsuit against the customer in Country X, the court in Country X will apply its own conflict of laws rules. It is possible that the conflict of laws rules of Country X may follow a very common rule that looks to the situs of the asset (often referred to as *lex re sitae*). Under that conflict of laws rule, the issues are resolved under the substantive law of the jurisdiction in which the securities are viewed to be located. Let's say that under the law of Country X securities issued by an issuer located in Country X are themselves viewed to be located in Country X. In that case, the substantive law of Country X will determine how the creditor obtains the judgment lien and how the priority conflict between the lender as secured party and the judgment lien creditor is resolved. The creditor may under the substantive law of Country X attach the securities by serving process on the issuer in Country X. Moreover, any judgment lien of the creditor arising from the service of process may under the substantive laws of Country X have priority over the lender's security interest if the lender has not previously taken steps under the law of Country X for its security interest in the securities to obtain priority over a subsequent judgment lien. (A similar analysis would apply if, under the conflict of laws rules of Country X, the securities were viewed to be located in Country Y where the clearing corporation is located or where share certificates for the securities are physically held.)

This problem is especially acute under United States bankruptcy law. If the customer were to become a debtor under the U.S. Bankruptcy Code, the customer's bankruptcy trustee would have the hypothetical status of a creditor who has obtained a judgment lien against the customer's interest in the securities at the time of the commencement of the bankruptcy case. If the lender's security interest in the customer's interest in the securities would not prevail over a judgment lien under applicable non-bankruptcy law, the security interest will be set aside in the

bankruptcy case, and the lender will be treated as a general unsecured creditor of the customer. It is unclear under the Bankruptcy Code whether the bankruptcy trustee's status as a hypothetical judgment lien creditor could be that of a hypothetical judgment lien creditor in Country X. If that were the case, then the bankruptcy trustee could set aside the lender's security interest and treat the lender as a general secured creditor even though the lender's security interest in the customer's interest in the securities would have been senior to the judgment lien under New York's substantive law.

As a result, for the lender to have confidence that its security interest would be given priority over the lien of the judgment lien creditor or even would not be set aside in the customer's bankruptcy case, the lender would need to comply with not only New York substantive law but also the substantive law of Country X. The lender's doing so will involve additional expense that may decrease the availability or increase the cost of credit to the customer. Moreover, if the lender were extending the credit to the customer based on a security interest in securities issued by issuers or held through clearing corporations in numerous countries, the costs of complying with the substantive law that might be applicable under the conflict of laws rules of each country in which litigation might be brought could be prohibitive.

How the Convention Would Address the Problems

The Convention would address these problems by creating a single, uniform conflict of laws rule that would apply the substantive law of the country whose law is chosen by the custody or securities account parties to govern their agreement or, alternatively, to govern the issues covered by the Convention. The only limitation is that the chosen law must be that of a country in which the relevant bank, broker or clearing corporation maintains an office for dealing in securities - often referred to as the "Qualifying Office" test.

In our example, if the United States and Country X had adopted the Convention and litigation were brought in Country X and so long as the custodian and the customer have agreed that the custody agreement or, alternatively, the issues covered by the Convention are governed by New York law, Country X would apply New York substantive law to determine how the creditor obtains the judgment lien and how the priority conflict between the lender as secured party and the judgment lien creditor is resolved.

Accordingly, the Convention, by applying a single, uniform conflict of laws rule would simplify very complex conflict of laws issues that arise under current law, provide greater certainty for transacting parties, dramatically reduce transaction costs and potential litigation claims, and provide a basis for increasing the availability and reducing the cost of credit. The Convention would also, by resolving the relevant conflict of laws issues, reduce risks in the entire cross-border securities clearance and settlement system that could arise in resolving competing claims in times of financial crisis.

No Disruption of Current Practices in the United States

Adoption of the Convention would not in any material respect disrupt current practices in the United States. The Convention is largely consistent with the domestic commercial law in the

United States, namely Article 8 of the Uniform Commercial Code as adopted in every state of the United States and the District of Columbia. Article 8 contains choice of law rules that are substantially the same as the conflict of laws rules of the Convention. The main difference is that Article 8 does not have a Qualifying Office test. However, this difference is expected to have little effect in practice.

If the Convention were to become effective, it would apply to pre-effective date transactions. Nevertheless, on account of interpretive rules contained in the Convention, it should not be necessary in most cases for pre-effective date agreements to be modified to account for the Convention. Even so, many private parties have already been inserting into their contracts a clause that would address the Convention if the Convention were to come in effect.