Uniform Law Commission
NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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The Honorable Diane Larson, Chair
The Honorable Bob Paulson, Vice Chair
North Dakota Senate Judiciary Committee

RE: SB 2364, To Amend Provisions of the Uniform Commercial Code

Dear Chair Larson, Vice Chair Paulson, and Members of the Committee:

Thank you for the opportunity to speak with you about Senate Bill 2364. This legislation to amend the Uniform Commercial Code has been introduced in eight states, including North Dakota, but it has not been enacted anywhere, and for good reason. There is a process for amending uniform laws. Anyone can submit a proposal to the Uniform Law Commission, which updates its model laws regularly. It is telling that the proponents have never contacted the ULC to propose their amendments. They suggest that this amendment will protect investors in North Dakota, but that is unfortunately not true.

The premise behind this legislation is a bizarre and unfounded claim in a self-published book called “The Great Taking.” The author of that book claims that at some future point in time, large financial institutions will decide to collude to create a cataclysmic financial crisis and use the opportunity to take financial assets from their own customers on a massive scale.

It is difficult to see how large, publicly owned financial firms who compete against each other for customers could suddenly shift course and collude with each other to steal their own customers’ property, or how the shareholders and employees of those firms would somehow be better off with a pile of stolen property and a horde of angry, newly broke customers. Nevertheless, that implausible scenario is the so-called “problem” that this bill is supposed to fix. If you want to see for yourselves how this false narrative has gained traction, it won’t take much searching online to find videos that promote this bizarre theory while advertising alternative investments to frightened viewers.

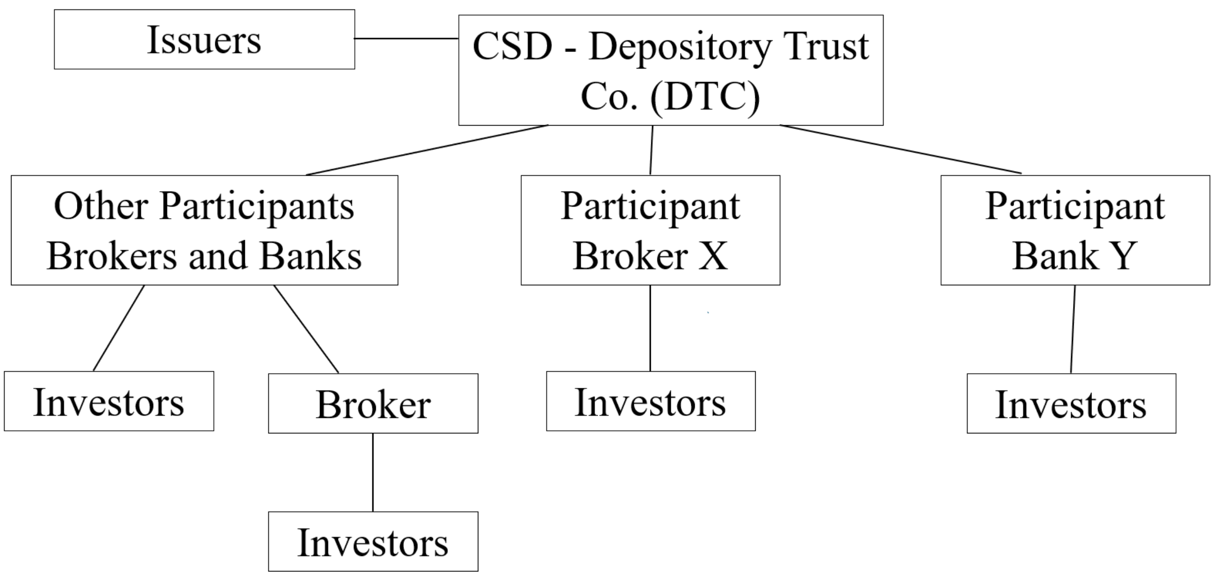
I want to be perfectly clear that I do not believe any of the sponsors of this bill are disingenuous. I presume they are hearing from misinformed constituents asking them to take action to protect their investments. But that is not what this bill does. Existing securities laws and regulations already provide strong protection for investors, and this bill would not add any additional safety. Instead, it would defeat the purpose of the Uniform Commercial Code by making North Dakota law different from the law of every other state, adding friction to interstate transactions and driving up costs for individuals and businesses in North Dakota, and for any counterparties in other states that transact business with North Dakotans.

It took a full semester of law school for me to learn just the basics about the federal and state laws that regulate the sale of securities and protect investors—I cannot give a complete overview in the time allotted for this hearing. Instead, I will explain the purpose of Uniform Commercial Code Section 8-511, which Senate Bill 2364 proposes to amend. If any of the committee members want more information after the hearing, I will be happy to follow up.

To understand the purpose of UCC Section 8-511, it must be read in conjunction with other law. In general, the law that regulates banks, brokers, and securities dealers and protects their customers' investments is federal law. Those laws make it illegal for an investment firm to use its customers' investment property for the firm's benefit.[1]

The Uniform Commercial Code is not regulatory law—it is private law that governs the rights of parties who enter into commercial transactions with each other. Because the UCC has been enacted in every U.S. state, commerce in the United States is predictable and efficient. Much litigation is avoided because the UCC sets out rules that follow sound business practices and conform to the expectations of buyers and sellers.

Article 8 of the UCC governs transactions involving investment securities and was last amended in 1994 to keep pace with evolving technology. Beginning in the 1960s, many U.S. investors began using the electronic holding system for securities because of its many features that benefit investors, like consolidated brokerage accounts with net tax accounting, near instantaneous trading, and the ability to place buy and sell orders at a limit price rather than at the market price. By the 1990s, nearly all investors used the multi-tiered electronic holding system, which is illustrated in the diagram below.



UCC Article 8, Part 5 was added in 1994 to provide rules for this modern electronic holding system. In the United States, companies that issue stock for public sale generally do so using jumbo certificates representing millions of shares. Those shares are held by a clearinghouse called the Depository Trust Company (DTC)[2]. All major securities dealers have an account with DTC, and DTC electronically credits each firm's account with shares of individual securities representing the holdings of all the firm's customers. Each firm in turn maintains individual accounts for each customer and credits each customer's account with the appropriate

[1] In particular, the Securities Investor Protection Act of 1970 as amended by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 and associated Securities and Exchange Commission regulations serve to protect investors' property from misappropriation by a securities intermediary.

[2] Other clearinghouses exist for other types of investments, but this example is illustrative of how they all function.

number of shares.

When a firm's customers trade, the firm can reallocate shares from the seller's account to the buyer's account, and send payment from the buyer back to the seller. At the end of each trading day, each firm nets all of its customers' sales and purchases, and then either purchases shares from or delivers shares to the clearinghouse to settle accounts. The clearinghouse functions as a market for its member firms to exchange securities based on the net trades of each firm's customers.

With this background, we can begin to understand the rules in UCC Article 8. UCC § 8-503 states that all securities held by the firm (called a "securities intermediary") for its customers (called "entitlement holders") are owned by the customers and are not subject to claims of the firm's creditors *except* as provided in UCC § 8-511. UCC § 8-511 provides a general rule in subsection (a) stating that in the event of competing claims between a firm's customer and a firm's creditor, the customer has priority to the securities held by the firm. Subsections (b) and (c) then provide two exceptions to the general rule, which SB 2364 would delete. We'll consider each exception in turn.

Subsection (b) comes into play only when a customer intentionally pledges its investment property as collateral, either for a margin loan from the broker, or to fund a "short sale." In either case, the lender will take control of the shares pledged as collateral until the loan is repaid or the short sale settled. While the lender has control of the collateral, the lender naturally has priority over the customer in the event of a competing claim—no customer would expect otherwise after voluntarily pledging shares as collateral. Once the lender has been repaid, the shares are returned to the customer and the customer will again have priority over a lender's competing claim under subsection (a).

Subsection (c) is an exception for the clearinghouses that settle trades at the wholesale level between securities firms. Clearinghouses are tightly regulated under federal law and required to maintain lines of credit to ensure the timely settlement of trades. If one firm fails to deliver cash or securities to settle its customers' trades on time, the clearinghouse can use its line of credit to borrow the needed cash or securities and settle the trades as expected. In this way, one firm's failure does not affect the customers of other firms who were counterparties to the trades of the failing firm. This is an important systemic protection to ensure the system works to settle trades on time, as expected, even when problems occur.

In summary, the exceptions in UCC § 8-511 (b) and (c) serve important functions and do not pose any risk to investors. They have functioned as intended since North Dakota adopted the Article 8 amendments in 1997. Subsection (b) is only applicable to the small percentage of investors who voluntarily choose to pledge their securities in exchange for a benefit. Deleting this option will make credit more expensive or more difficult to obtain, putting North Dakota investors at a disadvantage compared to investors in other states. Subsection (c) only applies to clearinghouses and is necessary for a clearinghouse to maintain lines of credit required under federal law as a safety measure. The availability of credit is a systemic protection to ensure the clearinghouses can function as expected to settle each investor's trades in a timely manner and prevent one firm's failure from affecting other firms.

With that explanation, I urge the committee not to advance SB 2364. The bill addresses a problem that does not exist with a proposed solution that could only cause harm to North Dakota residents and businesses. I welcome any questions from the committee.