SB 2364

Senate Judiciary

Peach Garden Room

February 11, 2025

Madam Chair and members of the Senate Judiciary Committee, my name is Tim Karsky and I am Commissioner for the North Dakota Securities Department. I am here today to ask you to vote Do Not Pass on SB 2364. As you have heard in previous testimony, SB 2364 will make changes to N.D.C.C. §§ 41-08-51 and 41-09-25. As mentioned, several times, this section was adopted per the Uniform Commercial Code and mirrors the law throughout the country and as of today, no other state has adopted these amendments. In fact, South Dakota defeated the amendments last week. I believe there were approximately eight states that have looked at this issue and no state has adopted them, as of today.

I do not think North Dakota wants to become the first state to adopt this, which would make us the first non-uniform law state. Although I am not an attorney, I do think this would complicate businesses operating in ND and they may elect not to do business here.

The Uniform Commercial Code (UCC) is a uniform state law adopted by all fifty states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The UCC governs commercial transactions between private parties. The fact that all U.S. states have adopted the UCC in substantially identical form facilitates interstate commerce. North Dakota citizens and businesses can confidently enter transactions with counterparties in other states knowing that the background law governing their respective rights is the same in every United States jurisdiction.

Article 8 of the UCC governs transactions involving investment securities. It was drafted to operate in conjunction with federal securities law and regulations to facilitate interstate securities trading and protect investor interests.

The 1994 revision to Article 8 was necessary in part because of changes to the way in which most investors hold securities. Investments, like stocks and bonds, used to be issued on paper certificates. To sell a security, an investor had to endorse the certificate by signing it on the back and deliver the paper to the buyer. As trading volume increased this system became untenable and brokerage firms began to offer their customers computerized trading through a system of electronic holding. Over time, the electronic holding system for investment securities was adopted by most investors and the firms that serve them because of its many advantages over holding paper certificates. The securities markets that exist today allow for near-instantaneous trading, one-day settlement of trades, consolidated brokerage accounts, and many other efficiencies and conveniences that would not be possible in a market using paper certificates.

The 1994 revision of UCC Article 8 included a new Part 5, titled "Security Entitlements," that sets out the rights and obligations of investors using the electronic system for holding securities. This law, which has operated effectively for nearly thirty years on behalf of investors and businesses, has recently been criticized because of a misunderstanding about its investor protections. Specifically, the rules in UCC § 8-511 that govern priority in security interests have been misinterpreted as harmful to the property interests of individual investors.

Priority rules exist to settle conflicting claims. If more than one party claims an interest in the same securities, something has gone wrong with a transaction – one party has failed to deliver cash or securities to complete a trade. When that happens, the priority rule determines who receives the security and who must pursue another remedy, such as an insurance claim or a lawsuit.

The second faulty assumption is that individual shares of a security are traceable to a particular transaction. Under the electronic holding system that exists to facilitate computerized trading, securities are held by brokerage firms and clearinghouses in pools for the benefit of individual investor accounts. At the end of each trading day, all of the trades involving each particular security are settled, and shares are reallocated from the accounts of the sellers to the accounts of the buyers. But it would be impossible, in most cases, to identify any particular share of a stock or bond as changing hands in a particular trade. The investment's firm's obligation under the law is to hold a sufficient *total* number of shares of a security to satisfy the claims of *all* of its investors, not to determine which shares from the pool belong

to which investor.

Finally, critics make the faulty assumption that these exceptions giving priority to creditors benefit large financial institutions rather than individual investors. In fact, large financial institutions do not just trade securities for their own accounts – they trade securities on behalf of their customers. The priority rules under UCC § 8-511 exist to limit systemic risk when something goes wrong. If a single brokerage firm fails in its legal obligation to settle trades by delivering cash or securities, it is not only the failing firm's customers who potentially suffer a loss. The investors from other brokerage firms who are counterparties to the failing firm's trades could also face losses. The priority rules in UCC § 8-511 serve to protect investors by containing the losses to the firm that failed, rather than allowing a chain reaction that affects customers of other firms.

Madam Chair, I am still new to this position and learning daily, but I do understand the UCC and have worked with it on the banking side as a regulator or banker for over 40 years. I think it is important for all states regarding securities transactions operate under a uniform law. I would be happy to answer any questions you may have.