Applicable Law on Demobilized and Dematerialized Securities

by Wael Saghir

I. Introduction

In the world of business, companies are constantly looking to cut some of their transaction costs. To do that, some companies may decide to merge with other companies under the umbrella of a one big corporation where number of their transaction costs are reduced. In general and in order for a corporation to be created, financing is needed. This may come in the form of bank loans which are some of the means of financing. Another means that is used by corporations, which is also cheaper, is the issuing securities. The issuance of securities, a form of raising a firm's capital,[1] is governed by a complex bundle of legal norms with a combination of laws and regulations governing the trade in such types of loans. This is true on a national and an international level where a given investor in one state may invest and trade in securities in another state. The issue in such investments arise with regard to the in the applicable law to such transaction. This is true especially since the trend is heading towards demobilization or dematerialization of securities, therefore it is important to know what is the nature of securities and what are its governing laws in order to resolve the problem of conflict of law rules related to securities.

II. Nature of Securities

Securities are negotiable debt instruments that gives, to the bearer of the instrument, the right to a specific monetary value of corporation's the assets. This amount is equivalent to the amount of money loaned to the corporation added to that an added return on the initial loan promised by the cooperation.

Securities are a debt instrument by nature. They include a wide range of instruments. These instruments have been the core of Section 2 of the 1933 Securities Act of the United States. They include bonds, notes and debentures evidence of indebtedness, bills of exchange and bankers acceptances, commercial paper, drafts, real estate mortgages secured notes, and currencies.[2]

Debentures, according to the English Companies Act, which on of the sources of the U.S. Securities Act of 1933,[3] debentures are defined as any document that acknowledges indebtedness.[4]

[1] Gale, D., 'Standard Securities', The Review of Economic Studies , Vol. 59, No. 4 (Oct., 1992), 1, p. 731.
Retrieved From: < http://0-www.jstor.org.catalogue.ulrls.lon.ac.uk/stable/2297995>
Last Viewed: 13/6/2012
[2] U.S. Securities Act of 1933, Section 2(a)1.
[3] Rosin, Gary S., 'Historical Perspectives on the Definition of a Security', S. Tex. L. Rev. Vol. 28, (1986-1987). III(d). pp 604-605.
Retrieved From: <http://0-www.heinonline.org.catalogue.ulrls.lon.ac.uk/HOL/Page?handle=hein.journals/stexlr28&collection=journals&set_as_cursor=0&men_tab=srchresults&type=matchall587&id=587>
Last Accessed: 13/6/2012
[4] *ibid.*

In the *Landerth Timber Co. V. Landerth* case, the nature of securities was subject to clarification where the nature of stocks and shares were deemed to have the characteristic of negotiability.[5] Negotiability of a security means that, unlike tangible goods, the right of ownership cannot be claimed on a lost or a stolen bearer instrument. Following that justification, the bearer is considered as a *Bona Fide* bearer of the instrument, or bearer in good faith. In other words, possession of an instrument assumes its ownership. It should be clear that in the aforementioned case, it has been concluded that the Certificate of the share is regarded as an evidence of ownership of the shareholder's share in the capital stock not as a promise of payment. This ownership, according to the case, represents an existing interest in the corporation's assets.[6]

III. Nature of Laws governing Securities

Basically, securities are loans that takes place within the scope of a contract. It also entails a transfer of property from one party to another. Therefore it is subject to proprietary laws. Not only that, such transactions governing Securities are special in their nature and not known in Contract Law nor are their results from transfer of property known in Proprietary Law. Due to these reasons, the need to special laws to govern these transactions occurred. Since securities are special in their nature and are not only issued by corporation, but also by governments, and due to their sensitivity and volatility and what such volatility reflect on the economy and on the financial sector of the state where they are issued and traded, the need to specific tailored laws arose. A number of regulations were introduced to govern the trade with securities and to specify and organize the markets where such securities could be traded. The trade with securities has been regarded as Natural Monopolies with one sole regulator and one regulation governing it.

It is noted that the amount of liberalization given to the market where securities are being trading, is reflected within lowering national regulatory barriers and entry requirements. [7] This has made securities markets head towards a more international market rather than pure national markets.

The securities regulation came to introduce the concept of disclosure which ensures that all information about any corporation wishing to issue securities is made free and available to the public to study before making the decision to invest and grant a loan to a given corporation. This disclosure came in to fill the gap of flow of information which the Contract Law was not able to cover since the contract governing the trade in securities is different then those contracts cited by the contract law.

The contractual part of the trade of securities is governed by the Contract Law where parties can opt which courts could look into disputes arising from the contract and which law and so forth. While, on the other hand, determining if certificates issued by the corporation and granted to the investor is tangible or intangible and therefore if possessing it entails ownership or not was left to Proprietary Law to determine.

The importance of having laws and/or regulations governing the trade with securities or issuance of securities pauses great importance since leaving the trade with securities in the market freely without any boundaries would mean that the securities market would not be able to prosper.[8]

[5] *ibid* at 603.
[6] *ibid.*
[7] Bagheri M,, *International Contracts and National Economic Regulations, (*Kluwer Law International, London 2000), Chapter IV(5)2.2, p. 76.
[8] La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 'What Works in Securities Laws?', J.O.F., Vol.61. Issue 1. (February 2006). VI(d). pp 23.

It shall be noted that in the United States courts agreed that if a discretionary agreement is an investment contract it is, then, considered as a type of security and, therefore, governed by securities regulations.[9]

IV. Conflict of Laws Rule of Securities Regulation

Normally, and in international contracts, disputes may arise with regard to the applicable law on the contract and on the jurisdiction of which has the authority to look into disputes arising from such contract. This is normally known as conflict of law rules. Conflict of Law Rules may arise in contracts that are executed and signed in a given state over the applicable law of a certain jurisdiction. Therefore Conflict of Law Rules is not only related to International Conflict rather, also, to conflict of national laws. The conflict normally arises with respect to what substantive law refers to.[10] For the purpose of solving such conflicts, states adopted a bundle of conflict of laws rules.

Conflict of Laws Rules of a given state, known as default rules, with regards to securities, is solved by the determination of the nature of the conflict regarding the security. I.e. If the conflict occurred with regards to the transfer of ownership then the governing law over this conflict is the Proprietary Law whereas if the conflict occurred in the contractual aspects of the trade with security's instruments then the Contractual Law is the governing law. Lastly, Securities Regulations takes place whenever a corporation fails to ensure the flow of information to the public or if there was any defamation or deception or any action that would falsely encourage investors to invest in a given corporation. For that, it was stated that disclosure is the main subject of securities regulations.[11] Securities regulation took place in order to balance the flow of information between both parties where, if the trade in securities was left to Contract Law alone, there will be an imbalance of information. i.e. One party will have more information than the other.

In the United States, and in order to identify the nature of a transaction and therefore the law governing it, one of the landmark cases led to a test known as the Howey Test. The Howey Test is conducted to find out the nature of a transaction and whether such transaction falls under the definition of the SEC's Investment Contract and, therefore, considered a Security or not.[12] Briefly, merits of the test states that an investment contract is one where a given party of a contract invests his money in a common enterprise expecting profit solely from the efforts of the other party.[13]

On the other hand, Conflict of International Laws Rules of Securities is treated within the following scope; parties are free to enter into any contractual relationship and to choose whatever law to govern this relationship and at the country of their choice according to article 3 of the Rome Convention.[14] For that, if there was no such choice of Forum or the Law governing the contractual relationship, it is up to the connecting factors and the place of characteristic performance of the contract to determine the applicable law and forum.[15] After determining the forum with authority to resolve the dispute, the court shall look into the nature of the dispute regarding the Security. If the dispute was over the proprietary rights or contractual rights then these matters are resolved by the rules embedded in the Rome Convention in article 4.[16] Whereas if the subject of such dispute was

[9] Alcser, M. G., 'The Howey Test: A Common Ground for the Common Enterprise Theory', U.C. Davis L. Rev., Vol. 29, (1995-1996) p.1218.
Retrieved From: <http://0-www.heinonline.org.catalogue.ulrls.lon.ac.uk/HOL/Page?handle=hein.journals/davlr29&collection=journals&set_as_cursor=0&men_tab=srchresults&type=matchall1228&id=1228>
Last Accessed: 13/6/2012
[10] Bagheri, M., 'Conflict Of Laws, Economic Regulations and Corrective/Distributive Justice' 28(1) University of Pennsylvania Journal of International Economic law, (2007), p 114.
[11] Palmiter, A. R., *Securities regulation: Examples and Explanations*, (Vol.1. Wolters Kluwer Law & Business, April 2008) , p.1.
[12] SEC v. W.J Howey Co 328 U.S. 293 S Ct (1946)
[13] *footnote* 9 at p.1219.
[14] Rome Convention 1980. Art 3.
[15] *ibid* Art 4.
[16] *ibid* Art 4.

over the part governed by the securities regulation, then this is left to the courts of the state where the securities are registered. It shall be stated that at times, the conflict may rise between more than two states over the application of their laws or regulations over the matter at hand. In such instances the act of investigating over the legality of application of regulations becomes of great importance.[17]

It shall be noted that the Rome Convention subjected contractual rules, only, to its text and did not cite Securities. For that, their nature and characteristics were not known. Nevertheless, the convention recognized that a given state might have an interest in applying its own mandatory rules.[18]

Securities Regulations are related closely to the level of development of the economical and financial sectors of a given state. They are considered to be a matter of order[19] and no state will give up the application of its regulations over aspects related to such regulations even if they occurred on an international scale. This means that regulations in general, are not applicable on an extraterritorial level unlike some laws. The extraterritorial problem arises when one state assumes jurisdiction in another state over the matter at hand related to economic regulations or securities regulations.[20]

It is worthwhile mentioning that in instances where reciprocal treatment by states is granted on the basis of a bilateral agreement or treaty or on the basis of a memoranda of understanding, the reduction of application of sovereign regulation would be waived and the application of the foreign regulation maybe granted.[21] Some of the mentioned bilateral agreements may take the form of International information sharing.[22] Others could take the form of an International Organization of Securities Commission, IOSCO.[23]

It is concluded from the above, that, in order to determine whether an international securities dispute resulting from trade of securities in one state can be subject to laws and regulations of another, it is needed to find out a certain law or regulation is governing this relationship. If it is a matter of law then the Rome convention is applicable and Articles 3 and 4 of the said convention are the ones to consult. Whereas, if the matter of dispute has been subject to regulation then this shall be resolved according to the regulations of the state where the securities is issued after consulting any international agreement that a state have concluded which might entail otherwise.

V. Dematerialized Securities and the Conflict of International Law Rules

Due to technological advancements and in order to ease the trade with securities, buying and selling securities can nowadays take place via the internet. These advancements led to an electronic version of the trade with securities and led, as well, to access the international securities markets.[24] Even certificates issued as a proof of holing a security traded electronically is an electronic version

[17] *footnote* 7 at Chapter IV(3)1, p. 57.
[18] *footnote* 10 at p 141.
[19] *footnote* 7 at Chapter IV(2), p. 56.
[20] *ibid* at Chapter IV(5)2, p. 70.
And;
ibid at Chapter IV(5)2.2, p. 70.
[21] Dombalagian, Onnig H., 'Choice of Law and Capital Markets Regulation' Tul. L. Rev. Vol. 82, (2007-2008) IV(B) p. 1935
Retrieved from : <http://0-www.heinonline.org.catalogue.ulrls.lon.ac.uk/HOL/Page?handle=hein.journals/tulr82&collection=journals&set_as_cursor=0&men_tab=srchresults&terms=33%7CBrook.%7CJ.%7CInt&id=1921>
Last Viewed on: 13/6/2012
[22] Lash, W. H. III, 'International Securities Regulations', Int'l L. Vol. 31, (1997), p.362.
Retrieved From: <http://0-www.heinonline.org.catalogue.ulrls.lon.ac.uk/HOL/Page?handle=hein.journals/intlyr31&collection=journals&set_as_cursor=1&men_tab=srchresults&type=matchall374&id=374>
Last Accessed: 13/6/2012
[23] *ibid* at p.364.
[24] Effros, R.C., *Current Legal Issues Affecting Central Banks*, (Volume IV , IMF, April 1997). pp. 571-572.

and not a physical one in these electronic markets.[25] These advancements had also helped in increasing the speed of international transactions.[26] The concept of using technological advancements into securities markets comes from the idea that the lower the transaction cost the higher the volume of trading is and the easier it is for securities to reach investors.[27]

The effect of such advancements on laws and regulations should not have a different effect from the classical trade with securities. Whereas, the trade that is taking place electronically is still subject to a given securities market that follows a certain jurisdiction and therefore a specific securities regulation. This basically means that the laws or regulations of the said jurisdiction has the authority over disputes related to the trade. To elaborate more, if a dispute arose with regard to an electronic trade by a an investor of state A in the market jurisdiction of state B with the securities of a company belonging to state C, then the matter of conflict of laws of securities regulations might take in place and resolving this conflict would be no different than resolving the conflict arising in a classical physical trade of securities.

As for proprietary law, dematerialized securities are still certificates of securities. These certificates have a sole effect, i.e. they act as a proof of ownership of the bearer. Transfer of ownership happens through transfer of possession of the said certificate. Securities are negotiable instruments and therefore their negotiability will still be present in dematerialized securities. In that respect, it can be said that abandoning the physical certificate of the instrument and replacing it with an electronic version, as discussed earlier and according to the *Landreth Timber Co. V. Landreth* case, should not have any effect on the proprietary aspect of securities where the certificate is just a physical evidence of ownership.[28] The change into trading with securities electronically should not result in any problem save that in case this electronic version of the certificate was stolen or illegally traded then, in that case, the concept of negotiability of securities comes into application.

It shall finally be stated that when it comes the regulatory aspect that governs securities, the change from physical to electronic trading would not have any effect on the rules of disclosure and therefore the rules disclosure and securities fraud will still be present.

VI. Conclusion

Investors have, nowadays and due to technological advancements, an easy mean to trade with securities both in a national and an international securities markets. This, though eased up the trade, had proven to entail some legal challenges. Such challenges though present while trading with securities in national markets have proven to be more complex when trading internationally specifically when it comes to determining which law is the governs such trade and in which market jurisdiction.

Generally, there are number of facts that needs to be clarified in order to determine the governing law over security's-related disputes. Matters of conflict of laws rules of securities regulations pauses much difficulties when determining the nature of the dispute related to the trade with securities. Once that matter is resolved, then, afterwards, it shall be determined whether the issue is a matter of law or regulation and if a foreign law is to be applied or not.

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[25] *footnote* 11 at Chapter 1(1)5 , p.8
[26] *footnote* 7 at Chapter IV(5)2.2, p. 76.
[27] Maynard, T.H., 'What is an Exchange--Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange', Wash. & Lee L. Rev., Vol. 49, (1992). II(C)2. pp. 862.
Retrieved From: < http://0-www.heinonline.org.catalogue.ulrls.lon.ac.uk/HOL/Page?handle=hein.journals/waslee49&collection=journals&set_as_cursor=0&men_tab=srchresults&type=matchall852&id=852>
Last Accessed: 13/6/2012
[28] *footnote* 3 at. III(c). p. 603.

The Rome Convention in its Articles 3, 4 and 7, sat the limits to be followed in matters of conflict of laws and left the issue of resolving conflict of regulations to bilateral or multilateral agreements and memoranda of understanding between nations.

The trend in U.S. courts is towards applying their jurisdiction with regards to securities regulation beyond their territory.[29] In the U.K. on the other hand, the 1989 Act context does not govern actions and trades taking place with no connection with the U.K. The application of the act also depends on the location where the securities have been issued.[30]

As for dematerializing securities and how matters of conflict of laws rules are to be settled in such instances, it is concluded that dematerialization of securities has no effect on the nature of securities especially since proprietary law, as it was shown, allowed securities to be a negotiable instrument and that the certificate granted in return of purchase of a security is only a proof of ownership. Therefore, whatever the form that such certificate takes, it would still have the same legal effect. When it comes to conflict of laws of securities regulations over dematerialized and demobilized securities, there is no use in adopting a different approach other than the one adopted for materialized and mobilized securities to solve any conflict since the nature of the security did not change or alter.

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[29] *footnote* 7 at p. 80.
[30] *ibid*.