September 1994

Beyond G30: Update: A New Approach to the Commercial Law of Securities Holding Through Intermediaries: The Proposed Revisions of Article 8 of the United States Uniform Commercial Code

James S. Rogers
Boston College Law School, james.rogers@bc.edu

Beyond G30: update

A new approach to the commercial law of securities holding through intermediaries: the proposed revision of Article 8 of the United States Uniform Commercial Code

by James Rogers

In response to the tremendous interest shown by Participants concerning the G30 and the Beyond G30 recommendations, a series of special papers, each one focusing on one aspect of the Beyond G30 study, will appear with the Euroclear Review.

The first paper in the series looks at the Beyond G30 recommendations four and five covering legal reform in the context of the U.S. securities industry. James Rogers, a Professor at Boston College Law School, has done substantial work on securities pledging laws and currently serves as the Reporter to the Drafting Committee to Revise UCC Article 8.

Around the globe, participants in the securities markets are increasingly becoming aware of the need for modernization of commercial law to take account of the development of the system of securities holding through multiple tiers of intermediaries. In the United States, this concern has led to a project to revise Article 8 of the Uniform Commercial Code, which governs transfer of interests in securities, and the related provisions of Article 9 on pledges of securities.

The proposed revision of Article 8 uses a new concept — "securities entitlement"— to describe the interests of a person who holds a security through a securities intermediary, and a new term —"entitlement holder" — to refer to a person who has a securities entitlement. A new Part 5 of Article 8 specifies the rights of those who hold securities entitlements. The term "securities entitlement" is defined as the package of rights that a person who holds securities through a securities intermediary has against that securities intermediary and the property held by that securities intermediary. Like many legal concepts, however, the meaning of "securities entitlement" is to be found less in any specific definition than in the matrix of rules that use the term. In a sense, then, the entirety of Part 5 is the definition of "securities entitlement," because the Part 5 rules describe the rights of those who hold securities entitlements.

Under the draft code, a person acquires a securities entitlement when a securities intermediary indicates by book entry or otherwise that a security has been credited to a securities account maintained by the securities intermediary for the person. The rules provide that a securities intermediary must itself maintain a sufficient quantity of securities, however held, to satisfy all of its entitlement holders, and that the positions held by the intermediary for the entitlement holders are not subject to general creditors' claims.

Thus, a securities entitlement is not merely a claim against the intermediary, but a property right. The concept of a securities entitlement does, however, include a package of rights against the intermediary. The rules cover such basic matters as the duty of the securities intermediary to pass through to the entitlement holder the economic and corporate law rights of ownership of the security, including the right to receive payments, dividends, and distributions, and the right to exercise any voting rights. The rules also specify that the securities intermediary has a duty to comply with authorized entitlement orders originated by the entitlement holder and to convert the entitlement holder's securities position into any other available form of securities holding that the customer requests, such as delivering a certificate or transferring the position to an account with another firm.

The ultimate concern of investors, regardless of how they hold their securities, is that they be entitled to the benefit of the underlying rights against the issuer that comprise the security. In the traditional paper-based system, physical certificates were the mechanism by which rights to the underlying intangible interests were evidenced. Commercial law recognized that practice by treating the physical certificates as the embodiments of the underlying intangible interests, and applying ordinary property concepts to the certificates, as if they were themselves objects of value like diamonds or gold bullion.

In the modern indirect holding system, entries on the records of intermediaries are the mechanism by which rights to the underlying intangible interests are evidenced. Revised Article 8 seeks to recognize this practice by giving independent legal significance to the entries made on the records of intermediaries. Thus, the concept of securities entitlement plays a role in the rules for the indirect holding system analogous to the concept of securities certificate in the direct holding system. A person whose claim to a security is evidenced by possession of a certificate is described as the holder of a securities certificate. A person whose claim to a security is evidenced by entries on the records of intermediaries is described as the holder of a securities entitlement.

Beyond G30: Recommendation 4

Each country should modernize its securities ownership and transfer laws to (a) ensure that holders of securities through multi-tiered systems have property rights in such securities; and (b) include categorical choice-of-law rules to ensure the validity and finality of transfers at each tier of a multi-tiered holding system, including tiers governed by foreign law.

Although securities certificates and securities entitlements are both means of holding the underlying securities, the form of holding does matter for some purposes. At present, Article 8 attempts to describe the interests of all of the actors in the indirect holding system, at all levels, as interests in the same discrete item of property — the security. For example, suppose that Pension Fund purchases $10,000,000 of ABC Co. bonds, taking delivery through its Custodian Bank located in New York, and that the transaction is settled on the books of a clearing corporation, such as The Depository Trust Company (DTC). The current Article 8 rules say that when all of the entries are made on the books of Custodian Bank and DTC, this resulted in the "transfer" to Pension Fund of "a security," just as if Pension Fund had received possession of a physical certificate. For many legal purposes, the characterization of the transaction as a transfer to Pension Fund of ownership of a security is entirely apt. For example, for purposes of financial accounting, it is obvious that Pension Fund, not Custodian Bank or DTC, is the owner of the security. For purposes of commercial law, however, many problems are created by the use of concepts drawn from the world of physical deliveries as the basis for legal analysis of the interests of those who hold securities through intermediaries.

The traditional Article 8 rules on securities certificates are based on the idea that the paper certificate can be regarded as a complete reification of the underlying right. The rules on transfer and the consequences of wrongful transfer can then be written using the same basic concepts as the rules for physical goods.

For example, a person's claim of ownership of a securities certificate is a right to a specific identifiable physical object, and that right can be asserted against any person who ends up in possession of that physical certificate, except to the extent that bona fide purchaser rules cut off the adverse claim.

The rules of revised Article 8 for the indirect holding system are based on entirely different concepts. A securities entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and its property. The idea that discrete certificates might be traced through the hands of different persons has no place in the revised Article 8 rules for the indirect hold-ing system. Rather, the fundamental princi-ples of the indirect holding system are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the security, and therefore that an entitlement holder can look only to that intermediary for its rights. The entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom the intermediary holds the positions, or third parties to whom the intermediary may have wrongfully transferred interests, except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing. The principle that an entitlement holder can look only to its own intermediary is not really a creation of revised Article 8. Article 8 only gives legal recognition to the factual realities of modern securities holding. In a multi-tiered system of intermediaries, only a person's own immediate intermediary knows anything about that person's interest. Each intermediary knows only the identity of its own customers and the extent of their positions. An upper tier intermediary's customer may be someone else's intermediary, but the upper tier intermediary has no way of knowing anything about its customer's customers. Accordingly, the realities of the marketplace dictate that an intermediary can only be held responsible to its own customers.

Beyond G30: Recommendation 5

Each country should modernize its securities pledging laws to (a) facilitate pledges of securities held through multi-tiered securities holding systems, including cross-collateralization; and (b) include categorical choice-of-law rules assuring respect of the validity of pledges at each tier of a multi-tiered holding system, including tiers governed by foreign law.

Although one can devise hypothetical situations where a particular customer might find it advantageous to be able to assert rights against someone other than the customer's own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system. Suppose, for example, that Intermediary A transfers investment property to B, that Intermediary A acted wrongfully as against its customers in so doing, and that after the transaction Intermediary A did not have sufficient securities positions to satisfy its obligations to its entitlement holders. Viewed solely from the standpoint of the customers of Intermediary A, it would seem that the greater the extent to which the commercial law rules permit the property to be recovered from B, the better off investors would be. B, however, may itself be an intermediary with its own customers, or may be some other institution through which individuals invest, such as a pension fund or investment company. There is no reason to think that rules permitting customers of an intermediary to trace and recover property that the intermediary wrongfully transferred work to the advantage of investors in general. To the contrary, application of such rules would often merely shift losses from one set of investors to another. The uncertainties that would result from rules permitting such recoveries would work to the disadvantage of all participants in the securities markets.

The shift to the securities entitlement concept greatly facilitates the rationalization of the legal rules in two areas that have been problematic under current law: (1) security interests (pledges) in securities, and (2) choice of law. The rules on security interests in securities in current Article 8 are, at root, still based on the conceptual structure of the pledge by physical possession. The theory presumably is that if the securities have been placed in the hands of a third party who is obligated to act on the instructions of the lender, the lender would be deemed to have "possession" of the securities. Revised Article 8 seeks to strip away the unnecessary confusion created by forcing these arrangements into the procrustean bed of the concept of possession.

Instead, the new legal rules are based on what the parties to such arrangements are actually doing. Under the rules of revised Articles 8 and 9, a pledge of a securities position held through an intermediary would be described as the creation of a security interest in a securities entitlement. If the arrangement is such that the lender has the ability to direct that the position be liquidated, the lender would be described as having "control," and the security interest would be fully enforceable and would have priority over other claims.

Another advantage of the securities entitlement concept is that it greatly facilitates the choice of law analysis of transactions involving intermediaries in different jurisdictions. Because present Article 8 analyzes the interests of all of the parties as interests in the same physical "security," general choice of law principles would seem to suggest that a key factor in determining the governing law, for transactions at any level in the pyramid of custody, is the location of whatever physical certificates may have been issued by the issuer. The securities entitlement analysis of revised Article 8, by contrast, invites a choice of law analysis that distinguishes among the different levels in the holding system. The basic choice of law principle of revised Article 8 is that the rights and duties of a securities intermediary and an entitlement holder with respect to a securities entitlement are governed by the law of the securities intermediary's jurisdiction. Under revised Article 8, the investor would be described as the entitlement holder of a securities entitlement through its custodian bank. The law governing securities entitlements recorded on the books of the custodian would be the law of the custodian's jurisdiction. The custodian bank might in turn be as the entitlement holder of a securities entitlement through another higher-tier intermediary, such as Euroclear. Thus, the Article 8 choice of law rules would direct one to Belgian law to determine the rights and duties of the custodian as a Euroclear Participant.

The use of new concepts and terminology can not, of course, eliminate all legal problems or uncertainties. Indeed, it must be recognized that using new concepts may itself present some risk of unforeseen complexities. The judgement of those who have been working on the revised Article 8 project in the United States — senior lawyers and law professors — is that there is much more to be gained than lost by taking a new approach. Indeed, the main virtue of the new approach taken in revised Article 8 may be that it forces lawyers and judges to confront the fact that the modern system of securities holding through intermediaries presents unique legal problems that need to be addressed directly rather than by trying to fit the new practices into a conceptual structure that evolved in a different era.

Revised Article 8 has been approved by the American Law Institute and the National Conference of Comissioners on Uniform State Laws, and is now being prepared for submission to individual state legislatures in the United States for their consideration and adoption. ■

The Euroclear System is operated
under contract by
Morgan Guaranty Trust Company
of New York
Euroclear Operations Centre
Boulevard E. Jacqmain 151
B-1210 Brussels, Belgium

Telephone: National 02 224 1211
International +32 2 224 1211
Telex: Belgium 61025 MGTEC B
B.I.C.: MGTC BE BE ECL