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Behind the Article 8 Ball

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BY JAMES STEVEN ROGERS

Behind the Article 8 ball

The law plays catch-up with indirect securities holding

Business lawyers deal with investment securities in many ways. In their professional roles, they are often called on to advise in the purchase and sale of securities or loans secured by investment collateral. In their personal roles, lawyers' hopes for a secure retirement often depend on the expected return from a portfolio of investment securities. Yet despite the importance of the subject, many lawyers have little familiarity with modern securities holding systems or with the law governing them.

Although many aspects of securities clearance and settlement are governed or influenced by federal securities law, the basic commercial and property law rules on which the securities holding system is based are matters of state law, governed by Article 8 of the Uniform Commercial Code.



Susan Wise



NEWS

A project to revise Article 8 is currently under way, and is on a fast track. The schedule calls for completion of the project and final approval at the annual meetings of the National Conference of Commissioners on Uniform State Laws and the American Law Institute this summer.

The focus of the project is to provide an adequate structure of commercial and property rules for the system of securities holding through intermediaries that has developed in the past several decades.

To understand modern securities-holding practices, it is useful to distinguish two different holding systems: the direct and the indirect. Consider two investors, John and Mary, each of whom own 1,000 shares of IBM common stock.

John has a certificate representing his 1,000 shares and is registered on the books maintained by IBM's transfer agent as the holder of record. Accordingly, he has a direct claim against the issuer, receives dividends and distributions directly from the issuer, and receives proxies directly from the issuer to vote his shares.

Mary has chosen to hold her securities through her broker, Able, Baker & Co. She does not have a certificate and is not registered on IBM's stock books as a holder of record. Rather, she holds her securities through a chain of securities intermediaries. Able, Baker & Co. and the other securities intermediaries are subject to common law obligations and detailed regulatory supervision designed to ensure that the benefits of ownership, including the rights to dividends and distributions and the right to vote, are passed through to Mary, but for many legal purposes the fact that she holds her interest in the securities indirectly cannot be ignored.

Indirect holdings

To understand the indirect holding system through which Mary holds her shares, we should consider where the records of the own-

ership of Mary's interest are kept. Starting at the top, if we looked at shareholder records of IBM, or of any other corporation whose shares are publicly traded on the exchanges or in the over-the-counter market, we would find that one entity — Cede & Co. — is listed as the shareholder of record of somewhere in the range of 60 to 80 percent of the outstanding shares.

Cede & Co. is the nominee name used by the Depository Trust Company (DTC), a limited-purpose trust company organized under New York law for the purpose of acting as a depository to hold securities for its participants, some 600 or so broker-dealers and banks. DTC's books

The indirect system permits huge trading volumes.

break down the total number of shares of each security that it holds in the aggregate into accounts for each of its participants.

Thus if Mary's broker, Able, Baker & Co., is a DTC participant, DTC's books will show Able, Baker & Co.'s aggregate holdings of IBM. Just as IBM's books show only a single entry for the DTC position, without any indication of the identity of the brokers and banks for whom DTC holds IBM stock, so too DTC's books will generally show only a single entry for the total IBM position of each of its participants, such as Able, Baker & Co.

Of the total block of IBM shares that Able, Baker & Co. holds

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through DTC, some portion may be held as Able, Baker & Co.'s own proprietary positions and another portion for its customers. Thus, we would have to turn to Able, Baker & Co.'s books to find the entry indicating that of the total block of IBM shares that it holds through DTC, 1,000 shares are held for the account of Mary.

The evolution of the indirect system of securities holding has made it possible to clear and settle the enormous volume of trading in the modern securities markets. At the time of the "paper crunch" in the late 1960s, the trading volume on the New York Stock Exchange that so seriously strained the capacities of the clearance and settlement system was in the range of 10 million shares a day. Today, the system can easily handle trading volume of hundreds of millions of shares on routine days. Even during the October 1987 market break, when daily trading volume reached the current record level of 608 million shares, the clearance and settlement system functioned relatively smoothly.

Virtually all individual and institutional investors who are active traders hold their securities through broker-dealers or banks acting as securities custodians. If all of these broker-dealers and banks held their securities themselves, then as trades were executed each day it would be necessary to transfer the securities back and forth among these broker-dealers and banks. Now that the great bulk of the actively traded shares are held through DTC, all that needs to be done to settle each day's trading is for DTC to adjust the amounts shown in the participants' accounts.

The present rules

The present Article 8 rules work reasonably well for the direct holding system in which the beneficial owners of securities are also directly registered as the holders of record on the issuer's books. Article 8 specifies how securities so held are transferred, what rights trans-

feres have, how transfers are registered on the books of the issuer, and what duties and obligations issuers have to register a transfer.

Investors in ordinary corporate securities who wish to hold them directly from the issuer generally must do so by obtaining certificates. At one time, it was widely thought that the solution to the problems of processing securities transfers would be to eliminate the certificate. In fact, Article 8 was revised in 1978 to provide for uncertificated securities.

The response of the markets, however, to new information technology has taken an unexpected form. The 1978 amendments contemplated a system in which issuers of securities would no longer issue paper certificates, but would keep electronic records of the holdings of the beneficial owners. Although such a system may yet develop, the response of the market to date has been different.

Securities are still commonly issued in certificated form, but the certificates are held by depositories rather than the ultimate owners. The depositories hold the securities on behalf of brokers and banks, who in turn hold for their customers.

The present Article 8 rules do not work well for the indirect holding system. Article 8 attempts to describe the interests of all of the actors in the indirect holding system, at all levels in the pyramid, as interests in the same discrete item of property — the security.

To take our example of Mary, who holds IBM stock through a chain of securities intermediaries, the current Article 8 rules say that when all of the entries were made on the books of IBM, DTC and Able, Baker & Co. to reflect that Mary had become the beneficial owner of 1,000 shares, this resulted in the "transfer" to Mary of "a security."

In the past decade, it has become increasingly apparent that this way of describing the interests of per-

sons who hold securities through intermediaries is unworkable. The basic rules of Article 8 are based on the assumption that changes in ownership of securities are brought about in either or both of two ways: delivery of physical certificates or registration of transfer on the books of the issuer.

Yet in the vast majority of securities trades settled today, neither of these events occurs. For most of the securities held through DTC, physical certificates representing DTC's total position do exist. These "jumbo certificates," however, are never delivered from person to person. Rather they are stored in guarded vaults, where they live out their wholly uneventful lives as testaments to the difficulties of adapting legal structures to rapidly changing commercial practices.

Just as nothing ever happens to these certificates, virtually nothing happens to the official registry of stockholders maintained by the issuers or their transfer agents to reflect the great bulk of the changes in ownership of shares that occur each day. Thus, the principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but accounting entries on the books of a multi-tiered pyramid of securities intermediaries.

The nub of it all

We have come to the basic problem.

Virtually all of Article 8's rules on how a change in ownership of securities is effected, and what happens if something goes awry, are keyed to the concepts of a transfer of physical certificates or registration of transfers on the books of the issuers. However, that is not how changes in ownership are actually reflected in today's trading system.

One of the most nagging problems of the present commercial rules for this indirect system is how one creates and perfects a security interest in securities held through

intermediaries. Traditionally, investment securities were secured by the possessory pledge, that is, the certificate that showed the security was physically delivered to the secured party.

Possessory pledges are not possible for securities held through securities intermediaries, since the investors do not have possession of certificates representing their interests. Currently, Article 8 does contain provisions designed to permit the creation and perfection of security interests in securities held through intermediaries, but they are still drawn from the conceptual model of the possessory pledge: They are based on the concept that if one wishes to pledge property that is in the hands of a bailee, notice to or attornment by the bailee may have the effect of giving possession to the secured party.

It is hardly surprising that using rules evolved for possessory pledges as the model for security interests in securities held through intermediaries produces uncertainty and confusion.

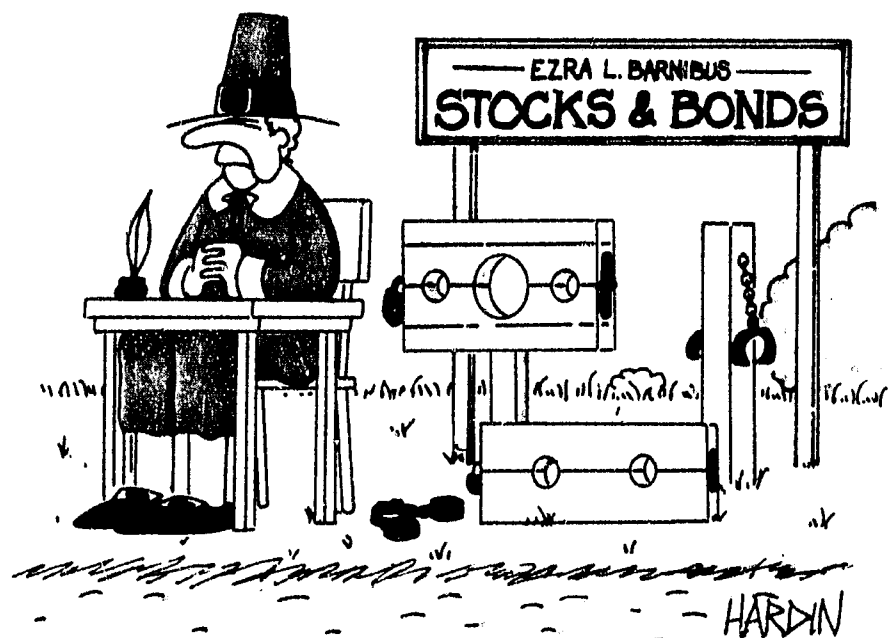
The concern about the adequacy of Article 8 rules on security interests was perhaps the key factor that

led to the current revision project. In several of the studies issued after the October 1987 stock market break, it was suggested that the uncertainties about the application of the present rules on perfection of security interests in securities held

Article 8 is based on the possessory pledge.

through intermediaries might discourage financial institutions from providing financing to securities firms in periods of market disturbance.

In response to these concerns, the Market Reform Act of 1990 gave the Securities and Exchange Commission the authority to promulgate regulations that would preempt state law on issues concerning the transfer and pledge of securities —



if the commission finds that such action is necessary for the safe and efficient operation of the securities clearance and settlement system.

The SEC has been following the Article 8 project closely, assuming that successful conclusion of the project will make it unnecessary for the commission to exercise its preemptive authority.

The Article 8 project will also simplify the law on government securities. The U.S. Department of the Treasury has for some years been working on proposed regulations governing the book-entry system for federal government securities. Treasury also has been following the Article 8 project closely, and has recently announced that it is withdrawing the proposed regulations, because it appears that the progress of the project will mean that Treasury will not have to adopt separate regulations.

The current draft

Although the revision project involves changes in many, if not

most, provisions of Article 8 and corresponding provisions of Article 9 on secured transactions, the basic approach taken in the current draft can be summarized rather briefly.

The revision abandons the attempt to describe all of the complex relationships in the indirect holding system as interests in discrete securities held by the clearing corporation at the top of the pyramid.

Instead, a new set of rules specifically designed for the indirect holding system is to be added to Article 8. These new provisions attempt to describe the core of the package of rights that a person who holds through a securities intermediary has against the securities intermediary and its property. These core rights include the right to have the securities intermediary pass through to the customer the corporate and economic benefits of ownership of the securities. These include the right to distributions and dividends and any rights to vote, and the right to have the securities intermediary transfer the securities to others or convert the

securities holding into any other form of holding for which the customer is eligible.

The new rules will also state explicitly the fundamental point that securities that a firm holds for its customers are not general assets of the firm subject to the claims of the firm's own general creditors. The proposed revision then gives a name to this package of rights, calling it a "securities entitlement."

The use of the "securities entitlement" concept is part of a general clarification of the terminology in Article 8. The present article uses the same term, "security," to refer both to the intangible interest, e.g. shares of IBM common stock, and to the physical certificates that show ownership of the intangible interests. The revised article uses the term "security" only to refer to the underlying intangible interest. The term "securities certificate" is used to refer to the pieces of paper that show ownership in the direct holding system.

The term "securities entitlement" is used to refer to the means by



which ownership is shown in the indirect holding system. "Securities certificates" and "securities entitlements" thus can both be described as a means of showing ownership of "securities."

The revised Article 8 also retains the provisions added in 1978 concerning uncertificated securities. The term "uncertificated security" is used in a fashion analogous to "securities certificate"; that is, it refers to the means by which ownership of securities is shown in a book-entry, direct-holding system.

Let us return to the example of John and Mary, each of whom own 1,000 shares of IBM. John is registered as the holder of record on IBM's books, while Mary holds through her broker. John's interest in IBM common stock would be described in the revised Article 8 as a "securities certificate." If John wishes to use his investment position as collateral for a loan, he would grant the lender a security interest in his "securities certificate." Under the proposed revision, Mary's interest in IBM common stock would be described as a "securities entitlement." If Mary wishes to use her investment position as collateral for a loan, she would grant the lender a security interest in her "securities entitlement."

Other changes

Along with the revision of Article 8, significant changes are proposed in the rules concerning security interests in securities. The proposed revision would return to the pre-1978 structure in which the rules on security interests are set out in Article 9, rather than in Article 8. Accordingly, the provisions of Article 9 dealing with investment collateral would be revised. In part, the changes are conforming changes to adapt Article 9 to the new concept of a securities entitlement.

The Article 9 changes, however, go beyond that to establish a simplified structure for the creation and

perfection of security interests in investment securities, whether held directly or indirectly.

In the case of the ordinary retail investor, the proposed rules would permit perfection of a security interest in investment positions, whether held directly or indirectly, by several methods. Filing of an ordinary Article 9 financing statement would suffice to perfect the security interest, although this would not necessarily assure the lender of priority against subsequent claims.

Alternatively, the lender could take the steps necessary to obtain "control," a new defined concept in the revision. In essence, obtaining "control" means taking the steps necessary to place the lender in a position where it could have the collateral sold off without the further cooperation of the debtor. Thus, for securities held directly by the debtor in certificated form, delivery of the certificate to the lender would suffice.

For securities held through an intermediary, the lender could obtain control in two ways. First, the lender could have the securities positions transferred to an account in its own name on the books of the securities intermediary. Second, if the securities intermediary is willing to do so, a lender could obtain control by entering into a tri-party agreement among the lender, the debtor and the securities intermediary. The securities intermediary would agree to act on the instructions of the lender to sell or transfer the investment assets. Such an agreement would suffice to give the lender "control" even though the debtor retained the right to trade and exercise other ordinary rights of an account holder.

Since alternative methods of perfection would be possible, a special priority rule would provide that a secured party who obtains control has priority over a secured party who does not obtain control.

These remarks, of course, only touch the high points of the current



revision project, focusing on individual investors. Somewhat different concerns are present in financing transactions involving securities held by broker-dealers for their own account. The revision has special provisions for those matters.

The drafting committee and the reporter encourage all lawyers to follow the project and to offer suggestions and comments. ■

To get a copy of the draft

Those who wish to obtain copies of the current draft should contact the office of the National Conference of Commissioners on Uniform State Laws, 676 N. St. Clair St., Suite 1700, Chicago, IL 60611. Comments can be sent to the reporter, Prof. James Steven Rogers, Boston College Law School, 885 Centre Street, Newton, MA 02159-1163.