

STATE OF NEW JERSEY
NEW JERSEY LAW REVISION COMMISSION

FINAL REPORT

REVISED UNIFORM COMMERCIAL CODE
ARTICLE 8 - INVESTMENT SECURITIES

NEW JERSEY LAW REVISION COMMISSION
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Final Recommendation

The Law Revision Commission recommends that the Legislature adopt Uniform Commercial Code Revised Article 8 with conforming and miscellaneous amendments to Articles 1, 4, 5, 9 and 10. Revised Article 8 improves existing law by reflecting contemporary practices of the securities industry and provides useful rules for the resolution of commercial disputes. Since securities transactions have national implications there is no justification for difference in local law.

Short Statement

The National Conference of Commissioners on Uniform State Laws (NCCUSL) approved Uniform Commercial Code Revised Article 8 "Investment Securities" at its 1994 Annual Meeting.¹ Revised Article 8 deals with the transfer of investment securities such as stocks and bonds. The revision was necessitated by the development of the indirect holding system for securities. Under this system, securities are mainly held through a chain of securities intermediaries starting with a central depository holding an immobilized certificate representing a large number of shares of the issuer. Existing Article 8 is based on the assumption that securities are held directly from the issuer. Since this assumption is completely at odds with how securities actually are held, existing Article 8 impedes the transfer of securities and affects the ability of securities firms to obtain bank financing.

The New Jersey Law Revision Commission has examined Revised Article 8 pursuant to its statutory obligation to consider uniform state laws for adoption in New Jersey. Five states: Arkansas, Idaho, Indiana, Nebraska and West Virginia, have already enacted the revision.² Seventeen other states are considering its adoption.³ The Chairman of the Federal Reserve Board and the Chairman of the Securities Exchange Commission support Revised Article 8 and have urged states to

¹ Cited as RUCC; for an overview see Mooney, Rocks and Schwartz, An Introduction to the Revised U.C.C. Article 8 and Review of Other Recent Developments with Investment Securities, 49 Bus. Law. 1891 (1994).

² NCCUSL, A Few Facts About Revised UCC Article 8 (1994). This fact sheet is available from the Chicago headquarters of the National Conference of Commissioners on Uniform State Laws, 676 north St. Clair Street, Suite 1700, Chicago, Illinois 60611. The fact sheet cited here is current to 10 May 1995.

³ Id.

adopt it because the legal uncertainties that arise when existing Article 8 is applied to the indirect holding system prevent banks from making loans to securities firms in times of financial crisis.⁴ This reluctance to finance securities transactions can lead to systemic risk, that is the failure of one financial institution may cause other institutions to fail. “Studies of the October 1987 stock market break indicated that uncertainty concerning the application of the old Article 8 rules to modern securities transactions adversely affected liquidity and placed significant stress on the securities clearance and settlement system.”⁵

Discussion

Existing Article 8 entitled "Investment Securities," enacted in New Jersey in 1961, covers the settlement of securities trades. “It sets the ground rules for implementing transfers and resolves disputes that may arise when different people claim conflicting interests.”⁶ Article 8 is “one part of the mosaic of laws under which securities are bought, sold and pledged.”⁷ Federal securities law establishes disclosure requirements of financial information for the sale of securities and regulates brokers, dealers and other market place participants. “State corporate and contract law establish the rights that owners of equity and debt securities have against issuers.”⁸ Article 8 supplements this scheme of regulation by setting rules about the transfer of securities.

When Article 8 was drafted in the 1940's and 1950's, the securities industry used a "direct holding system" to define the relationship between the issuer of the security and its owner. In the direct holding system, the issuer records the name of the owner on its books, thus giving rise to the "direct relation" between issuer and owner, and issues a certificate representing ownership or a debt relation. The rules of Article 8 covering delivery of securities and the rights and obligations of parties to securities transactions were predicated on the assumption that possession and

⁴ UCC 8 and Financial Markets 5 Spring 1995 containing remarks of Alan Greenspan about Article 8 revisions.

⁵ Rogers, Revised UCC Article 8 Why It's Needed What It Does (1994).

⁶ Id.

⁷ Id.

⁸ Id.

delivery of physical certificates were the key elements of transfer of ownership in the securities holding system.

In the 1960's, the business practices of the securities industry changed. In response to increased trading volume, the securities industry adopted the practice of issuing non-paper securities called in the terminology of Article 8 "uncertificated securities." This is because the "mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960's, leading to calls for the elimination of the physical certificates and development of modern electronic systems for recording ownership of securities and transfers of ownership."⁹ As a result, NCCUSL promulgated the 1978 amendments to Article 8 which added parallel provisions dealing with uncertificated securities to the existing rules of Article 8 on certificated securities. The system of securities holding contemplated by the 1978 amendments differed from the traditional system only in that ownership of securities would not be evidenced by physical certificates. Instead of surrendering an indorsed certificate for registration of transfer, an instruction would be sent to the issuer directing it to register the transfer on its books. The State of New Jersey enacted the 1978 amendments to Article 8 in 1990.

However, contrary to the assumption of the 1978 amendments that uncertificated securities would replace paper certificates, securities continued to be issued in certificated form. Virtually all forms of publicly traded securities are still issued in certificated form. However, these certificates are held, not by individual investors, but by clearing corporations in what is called an "immobilized" form, designating that the physical document remains in the possession of the clearing corporation and does not change hands to indicate transfers in ownership. This type of securities holding system is called the indirect holding system. "Settlement of securities trading occurs not by delivery of certificates or by registration of transfer on the records of the issuers or their transfer agents, but by computer entries in the records of clearing corporations and securities intermediaries."¹⁰ Thus, even after the

⁹ Prefatory Note, Revised UCC 8, 1 (1994).

¹⁰ Id. at 2.

1978 amendments, the rules of Article 8 did not deal effectively with the indirect holding system.¹¹

A large proportion of publicly traded securities are held in the name of the Depository Trust Company (DTC), and the clearing and settling of trades made with these securities is carried out by the National Securities Clearing Corporation.¹² For example, the shareholder of record for most shares of IBM traded on the New York Stock Exchange is the DTC. The members of the DTC -- about 600 banks and brokers -- have accounts at the DTC that show their respective positions in IBM stock. In turn, the members of DTC hold these IBM shares on behalf of their customers, say smaller securities firms. These securities firms then hold IBM shares on behalf of their retail customers -- individual investors. No person in the chain delivers physical stock certificates of IBM to execute a trade. Rather, DTC holds an IBM "jumbo certificate" and transfers of the ownership of IBM shares are recorded by adjustments to the participants' DTC accounts. The DTC members provide analogous clearance and settlement functions to their own customers thereby completing transfers in ownership at each level of the indirect holding system.

As is the case with DTC, most securities are represented by immobilized certificates. Just as nothing happens to these certificates as a result of daily trading, nothing happens to the official registry of stockholders maintained by the issuers or their transfer agents. "The principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's

¹¹ Id.

¹² The 1994 Annual Report of DTC states that it has in custody approximately 78% of shares of companies represented in the Dow Jones Industrial Average, 70% of all NYSE listed U.S. companies, 57% of shares included in the NASDAQ and 50% of American Stock Exchange-listed companies, 85% of the principal amount of outstanding corporate debt listed on the NYSE, and 95% of the principal amount of outstanding municipal bonds. See DTC AR 5 (1993). While the DTC is a major securities depository it is not the only depository in the US. Other depositories, such as those in Philadelphia and Chicago, exist and the Federal Reserve Banks maintain an indirect holding system for the great bulk of Treasury securities.

In a conversation with Carl H. Urist, Deputy General Counsel and vice president of DTC, Mr. Urist stated that the split between DTC and NSCC is of historical origin since banks did not want to become members of NSCC because of NSCC's policy of guaranteeing all trades. The banks did not want to accept the risk of failing brokerage firms. There is no reason why one institution cannot perform both the depository and clearance and settlement tasks. Mr Urist believes that NSCC now has banks as members.

books, but netted settlement arrangements and accounting entries on the books of a multi-tiered pyramid of securities intermediaries."¹³ Since the 1978 amendment of Article 8 is geared to concepts of transfer of physical certificates and registration of transfers on issuer's books, the existing Article 8 rules are out of touch with the reality of the securities market.

To accommodate the indirect holding system, NCCUSL decided to revise Article 8 and appointed Professor James Rogers of Boston College Law School as the Reporter. The drafting approach remained neutral as to the future development of the securities industry. "Revised Article 8 takes a neutral position on the evolution of securities holding practices."¹⁴ The revision assumes that "the path of development will be determined by market and regulatory forces and that the Article 8 rules should not seek to influence the development in any specific direction."¹⁵ As a result, the rules of existing Article 8 have been retained for the direct holding system and a new Part 5 added to set forth the commercial law rules for the indirect holding system. In addition, the rules for obtaining a security interest in securities have been moved to Article 9.

Equally important are the rules addressing the question of systemic risk, "that is, the risk that a failure of one securities firm might cause others to fail."¹⁶ If securities transactions are not final, and if a securities firm fails, persons injured by the failure may seek to unwind the transaction and thus threaten the solvency of other firms. Revised Article 8 reduces systemic risk by establishing rules to finalize securities transactions. As a further precaution, Revised Article 8 "establishes simple rules on the use of securities as collateral for loans in order to ensure that financial institutions can be assured of their legal rights in providing financing to securities firms that may be necessary to maintain liquidity in times of stress."¹⁷

Differences from Current Law

a. Indirect Holding System Rules

¹³ Prefatory Note supra note 9 at 5.

¹⁴ Id. at 6.

¹⁵ Id.

¹⁶ Rogers supra note 5 at 1.

¹⁷ Id.

An “entitlement holder” is a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary.”¹⁸ The term "security entitlement", defined in Section 8-102(a)(17), describes the bundle of rights a person acquires when that person owns a financial asset within an indirect securities holding system.¹⁹ It is the set of rights by the holder against the securities intermediary that holds the security on behalf of the holder. The rules that govern a security entitlement are set forth in Part 5 entitled "Security Entitlements" consisting of eleven sections. Revised Article 8 organizes the concept of security entitlement around three basic definitions: (1) "securities account," (2) "security entitlement" and (3) "security holder."

Securities entitlements are claims to securities accounts, somewhat analogous to claims depositors have on bank accounts, though the analogy is imperfect. A "securities account" is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."²⁰ A "security entitlement" "means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5."²¹ A person acquires a security entitlement when a securities intermediary credits a financial asset, or accepts the financial asset for credit, to the person's securities account.²² The securities intermediary need not hold the asset itself, since the securities intermediary may hold the asset through another securities intermediary. The security entitlement right in a financial asset is a property right of the security entitlement holder. It does not belong to the securities intermediary and is not subject to the claims of creditors of the securities intermediary. An entitlement holder's property interest with respect to a particular

¹⁸ RUCC 8-102(a)(7).

¹⁹ The Part 5 rules apply not only to securities, RUCC 8-102(17), but to financial assets RUCC 8-102(9). The term financial asset includes other interests, obligations or property that is held through securities accounts, such as money market instruments. While the latter are not Article 8 securities, since they are governed by Article 3, they are financial assets for purposes of the Part 5 rules of Revised Article 8.

²⁰ RUCC 8-501(a).

²¹ RUCC 8-102(17).

²² RUCC 8-501(b).

financial asset is a pro rata property interest in all interests in that financial asset held by the securities intermediary. The rights of entitlement holders are not determined by the time of acquisition. The right is not to a specific physical object, but a claim to property held by the securities intermediary.²³

While a security entitlement holder does not have a right to specific financial assets, the securities intermediary has a duty to provide the entitlement holder with all corporate and economic rights of security ownership. Thus, the securities intermediary must "maintain a quantity of financial assets corresponding to the aggregate of all security entitlements it has established."²⁴ A securities intermediary also has an obligation to pass the payment of dividends and other distributions to the entitlement holder.²⁵ In addition, the securities intermediary has an obligation to obey the instructions of the entitlement holder with respect to the financial asset including an order to sell or transfer the asset.²⁶ However, this duty does not preclude the owner of the security entitlement from conferring discretionary authority on the securities intermediary to manage the financial asset.

Since a security entitlement is a claim against a securities intermediary and not a claim to a specific physical object, an entitlement holder generally cannot assert claims against third parties even when the securities intermediary wrongfully has transferred the interest of the entitlement holder to the third party. A transferee who gave value and obtained control of the financial asset is protected against the claims of the broker's customers unless the transferee acted in collusion with the broker. This rule is justified on grounds of "the fundamental policies of investor protection that underlie [Article 8] and other bodies of law governing the securities business."²⁷ The Official Comment states:

"The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of

²³ Revised Article 8 does not determine how property is to be distributed on failure of the securities intermediary. "The Bankruptcy Code and Securities Investor Protection Act ("SIPA") provides that all customer property is distributed pro rata among all customers in proportion to the dollar value of their total positions." RUCC Official Comment 1 to RUCC 8-503.

²⁴ Official Comment 1 to RUCC 8-504; RUCC 8-504(a).

²⁵ RUCC 8-505(a).

²⁶ RUCC 8-506 and 507.

²⁷ Official Comment 3 to RUCC 8-503.

their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than from the post hoc perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. ... There is no reason to think that rules permitting customers of an intermediary to trace and recover securities that their 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."²⁸

As a general rule, if a securities firm fails and there is not enough securities to satisfy the claims of its creditors and customers, the claims of the customers prevail. However, if the creditors have taken “control” of the investment property, the claims of the secured creditors prime those of the customers. As a practical matter, a secured lender, such as a bank, takes control of securities within an indirect holding system when the secured lender requires the securities intermediary to transfer its holdings at the clearing company to the secured lender. In that case, the secured lender wins in a priority contest with the broker's customers, even though both the customer and the bank have control over the asset. The rationale for this rule is that it is needed to protect bank financing of securities firms and thus give securities firms access to capital in times of financial stress.

However, the rule should not lead to customer losses. First, a securities intermediary is forbidden from granting security interests in its customers' property. Second, Revised Article 8 and SEC regulations require brokers to maintain adequate quantities of financial assets to satisfy customers' claims. Third, SEC and self-regulatory organization inspections enforce these requirements. Even if a customer does sustain a loss due to the failure of his securities firm, the customer is protected against loss from a shortfall by the Securities Investor Protection Act (SIPA). Customers are insured under SIPA up to \$500,000 in shortfalls after distribution of the property of the insolvent securities intermediary. “This means that a customer with a claim for \$5 million of stock who received \$4.5 million from the pro rata

²⁸ Id.

distribution would then receive an additional \$500,000 worth of securities from SIPA.”²⁹

b. Creation and Perfection of Security Interests

The creation and perfection of security interests in investment property “have been taken out of Article 8 and placed in Article 9, thus returning to the structure used prior to the 1978 amendments.”³⁰ A security interest in investment property may be perfected by taking control of investment property or by filing a financing statement. The term “control” means roughly “that the secured party has taken whatever steps are necessary, given the way the investment property is held to ensure that the collateral can be liquidated without further action by the debtor.”³¹ A secured party who has control of investment property has priority over a secured party who has filed but does not have control.

With regard to a security entitlement, the term “control,” defined in Section 8-106, means (1) a purchaser has become the entitlement holder, or (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder.³² Assume a customer (A) borrows money from his bank (B) using his investment property held by his securities intermediary (SI). A instructs SI to transfer the shares from his account to B’s account at SI. The bank has control because it is an entitlement holder of the investment property. Now assume A, B and SI enter into an agreement by which SI will act on instructions from B about the stock but that A will continue to receive dividends and other payments. The bank has control because the securities intermediary will act on its instructions. A written and signed security agreement are not needed to perfect a security interest based on control pursuant to agreement among the customer bank and his securities firm.

Alternatively, a security interest in investment property may be perfected by filing. The secured creditor must obtain a written and signed security agreement and

²⁹ Rogers, supra note 5 at 3.

³⁰ Rogers supra note 5 at 4; see Mooney, Rocks and Schwartz supra note 1 at 1896-1902.

³¹ Rogers, supra note 5 at 4.

file a financing statement containing an adequate description of the collateral. A secured creditor who perfects by filing runs the risk of losing its protection to a creditor who perfects by control, regardless of the time of filing and of whether the control creditor knows of the filing. The rationale for rejecting the “first in time” rule of Article 9 is that the “control” rule recognizes that the securities industry is not in the habit of perfecting its security interests by filing and rewards the creditor who takes all steps necessary to gain control and thus be in a position to foreclose the collateral on default. The filing requirement does not apply to non-control creditors making financing arrangements for securities and commodities firms. These financing arrangements are automatically perfected when they attach.

As noted already, the general priority rule is that a creditor with control has priority over all other secured creditors. In cases of “dual control,” such as where a securities firm and a bank have control because a customer grants a security interest in his accounts first to the firm holding the accounts and then to an outside bank, the security interest of the securities firm primes that of the bank. Where two banks have control over the investment property of a securities firm, such as when the securities firm, a clearing corporation and the banks enter into agreements, the banks share pro rata in the investment property if it is discovered that they hold the same securities.

³² UCC 1-201(33) defines “purchaser” as “a person who takes by purchase. The term “purchase” means a “taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property.” UCC 1-201(32).