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Remarks of Sandra M. Rocks
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on the U.S. Commercial Law Response to the Development of Intermediated Securities Holding Systems

October 27, 2006

As the title of my presentation indicates, I will be offering you a perspective on the commercial law response in the U. S. to the transformation of securities holding patterns that has taken place over the last half century. This perspective will be offered from the point of view of a lawyer whose practice has focused primarily on security interest and bankruptcy law issues in the context of representing industry participants in derivatives, securities lending, margin lending, repurchase transactions and securitizations, as well as the rather more straightforward secured bank loan facilities.

In the U.S., putting aside some fascinating aspects of our federal system, the commercial law rules governing transactions involving investment securities – whether outright conveyances or security interests – are part of a statutory scheme called the Uniform Commercial Code. Technically, this is a model law that is offered to the states for adoption, and only when so adopted does it have any force of law. Two articles of this code are relevant for today's discussion: Article 8, entitled "Investment Securities", and Article 9, entitled "Secured Transactions."[1] All 50 states and the District of Columbia have adopted versions of these two articles that are uniform in all respects relevant for our purposes. It is important to note,

[1] All statutory section references herein are to these Articles.

however, that these articles operate within a context of general contract law as well as a context in which many – but not all – of the relevant players are subject to regulatory oversight.

A long, long time ago, these two articles dealt with investment securities only in physical form. With a very narrow exception for clearing corporation activities (which for the most part was located entirely in New York), there was no real commercial statutory law recognition of the multi-layered holding patterns that have become so prevalent. Indeed, when the U.S. Treasury decided to take action in the face of the "paper crunch" in the 1960's – in which securities transactions in large numbers failed to settle due to inability to deliver the paper certificates in timely fashion as trading volume grew – it took two contradictory steps. First, it created completely dematerialized securities. No certificate anywhere – simply entries on the records of Federal Reserve Banks (which served a quasi-transfer agent role). These securities could then be moved by electronic entry alone. (Many countries have now done this, of course.) And yet, for commercial law purposes – since this is not really a subject of federal law – the enacting regulations "deemed" these securities to be maintained in "bearer definitive form at the Federal Reserve Bank". Technology was obviously out in front, but the securities needed to find a home in a commercial code that knew only paper. (Paperless securities would have been considered "general intangibles" in UCC parlance, a category excruciatingly unsuitable for a variety of reasons, not the least of which was that UCC searches and filings would have been necessary for utilizing such securities as collateral – an approach impossible to adapt to most transactions in fungible securities.) In the regular corporate market in the U.S., dematerialization did not occur, but another phenomenon had similar effect: immobilization and intermediation. More and more securities were held by – and in some cases issued directly into – clearing corporations, to be held for participants who in turn held for their customers and so on. The split between what one might consider "legal title" – i.e., the person who is the registered owner as far as the issuer is concerned – and beneficial ownership – i.e., the person to whom the economic benefits of ownership were to flow – was recognized in practice but not explicitly as a matter of statutory language. Revisions to the UCC in the late 70's attempted to recognize these phenomena by creating a definitive list of how interests in securities could be conveyed (whether outright or by way of security interest) and introduced a pro rata sharing rule for situations in which holdings were insufficient to cover the positions of investors. Without belaboring the historical aspect of this presentation, I will simply note that the definition of security limited the

scope of the statute's applicability, notwithstanding the market's identical treatment of many different types of investments. Moreover, the rules suggested that the most basic, determinative factor was whether the security itself was certificated or uncertificated, and each person having an interest in the security was treated as though that person had an interest in the underlying security itself, which interest could (potentially) be traced into the hands of any purchaser (with a limited exception for transfers within the clearing corporation context).

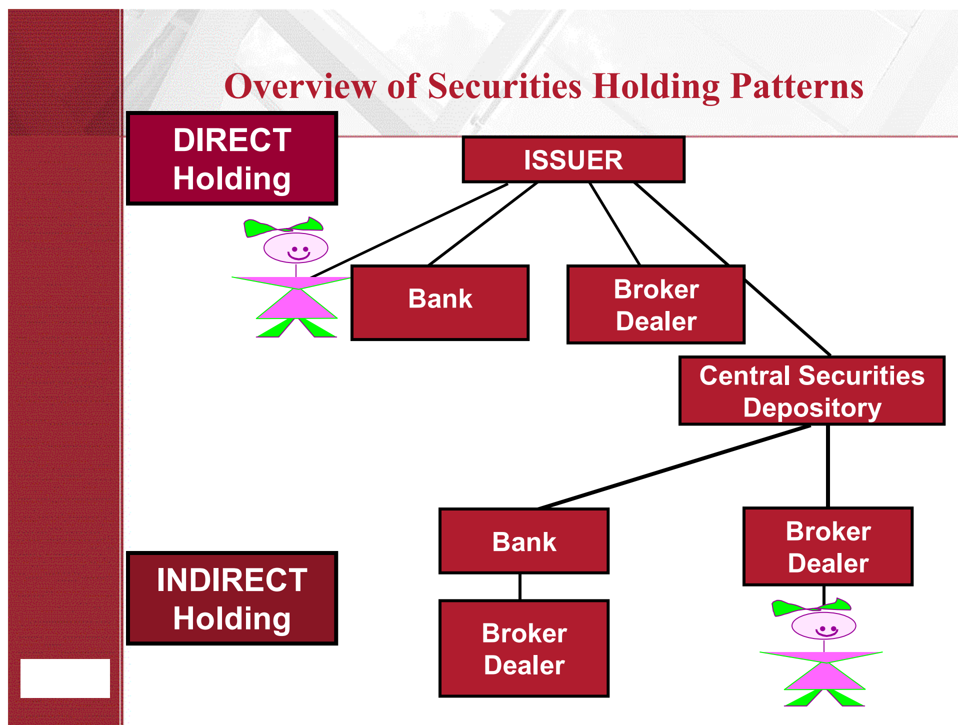
Although these shortcomings were becoming widely recognized, and the uncomfortable fit of the federal regulations for securities maintained solely in the form of entries in the records of Federal Reserve Banks with the state commercial law scheme was a significant source of legal uncertainty, it took a fairly significant market disruption in the late '80's to jump start the law revision process. Efforts on the state law and federal regulatory fronts played leap-frog, as drafts of proposed revisions to federal regulation were put out for comment and, with the threat of greater federal preemption hanging in the air, the appropriate groups began the process of revising Article 8 (with conforming amendments to Article 9). Simultaneously, various revisions to U.S. bankruptcy law – which generally annoys creditors and counterparties by interrupting enforcement of rights and sometimes avoiding transfers of interests in property – were adopted during the 80's and 90's to free certain market participants from these adverse consequences. Briefly – and these are very technical rules with many limitations that do not need elaboration for our purposes – repurchase agreements, futures contracts, securities contracts, and swap agreements are afforded special protection which allows certain counterparties to exercise their contractual remedies and access and retain the value of their collateral notwithstanding a bankruptcy proceeding in respect of the other party (and this "safe harbor" phenomenon appears not only in the U.S. Bankruptcy Code, which is available to most general corporate entities, but in the federal receivership regime governing most depositary institutions). These parallel movements had a common goal: to increase legal certainty in contexts for which systemic risk was a concern.

Turning to a more in-depth look at the principal features of the commercial law approach in the U. S., I would like to outline what I believe to be the key, or over-arching principles of the commercial law rules relating to interests in securities held with intermediaries that have provided a framework which accommodates market developments in securities holding

and trading patterns and thus a foundation for the robust legal certainty required by credit departments and regulators alike.

PRINCIPLE 1 - Recognize and, to the extent possible, anticipate innovations in holding patterns and the assets that may become subject to such innovations.

The law needs to grow with the market. Right now in many jurisdictions the market is way out front. No one needs to be told that any commercial law revision project should aim to address the manner in which assets are in fact being held and transferred – assuming there is no policy reason to the contrary. The harder task is to craft rules that have a good long shelf life – and thus are flexible enough to accommodate future holding patterns – and by this I mean without resort to artifice or attenuated legal analogies. UCC Article 8 attempts to be accommodating in two ways: first, by recognizing a concept of indirect holding that is unlimited in terms of participants and the number of potential intermediaries in any given chain, and second, by being even more limitless (and this concept exists – see Cantor's Theorem) in terms of what might in the future be held in the indirect holding system as we know it. This latter accommodation was accomplished in the U. S. through the use of the wide-open gatekeeping definition of financial asset that, as many of you may know, includes <u>any property an intermediary agrees to treat as a financial asset</u>. (One current example of a non-traditional asset being treated as a financial asset is a life insurance policy. This approach has begun to appear in the "life settlement" business, as investors seek to acquire and transfer interests in life insurance policies without the need to involve the insurer when changing "ownership".) As for the legal recognition of holding through intermediaries, under the UCC the terminology used for securities as to which a person has a direct relationship with the issuer is called "direct holding" and for securities or other financial assets held through one or more intermediaries, "indirect holding."



The question of who, as a corporate or regulatory matter, is permitted to act as an intermediary and what such intermediaries are permitted to hold and deal with on behalf of themselves and others was left to other law. (And the commercial law governing a financial asset in its natural state – i.e., outside the securities account itself – was also untouched.)

PRINCIPLE 2 – Recognize and/or create an appropriate concept of property interest.

In the U.S. – generally speaking – the corporate and commercial law rules regarding the nature of an investor's relationship with an issuer of securities (part of the direct holding system) did not need adjustment – nominee holdings, split legal and beneficial interests, passing through of benefits, etc. were already recognized and thus ready for integration with the indirect holding system. But the extent of intermediation that had developed and the inherent fungibility of many of the financial assets involved led to a departure from viewing an investor's interest in securities held indirectly as a property right traceable in all respects to an underlying security or other financial asset.

For indirect holding, the questions became what is the nature of the beneficial "owner's" property interest and what are the basic rights a beneficial owner has against its intermediary (and others) with respect to that underlying security or other financial asset.

So a "security entitlement" (defined in Section 8-102(a)(17)) was born: "'Security Entitlement' means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5", which rights and interests include:

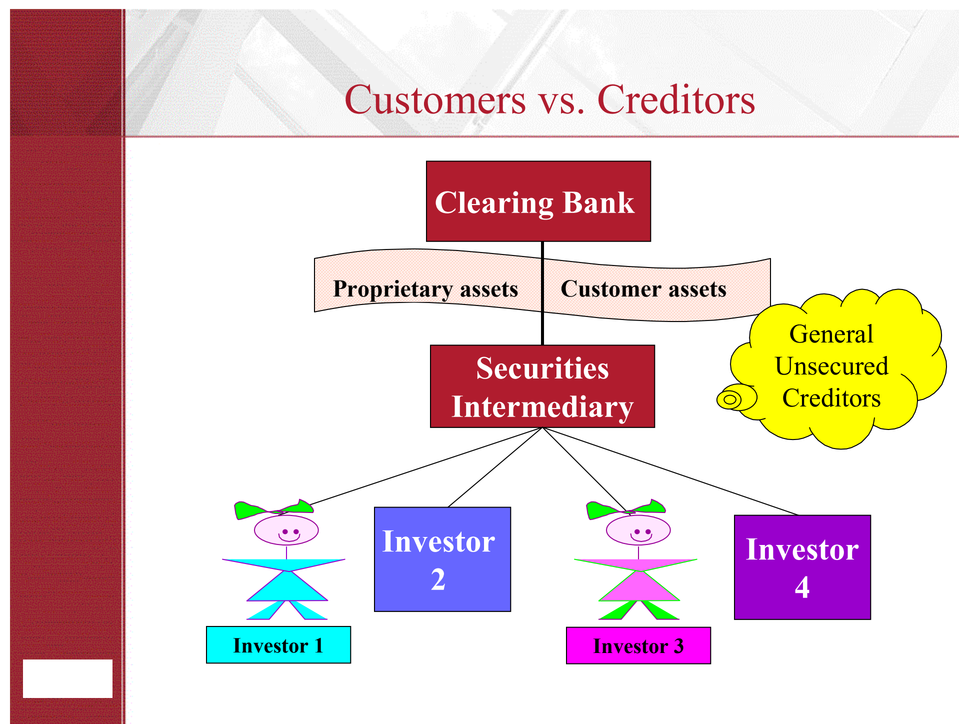
- a pro rata property interest in the relevant financial assets
- securities intermediary's obligation to maintain sufficient financial assets to cover positions it creates by crediting securities accounts
- duty of securities intermediary to obtain and remit payments or distributions made by issuers
- duty of securities intermediary to exercise rights (e.g. voting) as directed by entitlement holder
- duty of securities intermediary to comply with transfer instructions of entitlement holder
- duty of securities intermediary to change entitlement holder's position to another available form of holding for which such entitlement holder is eligible (e.g., one can obtain a paper certificate only when and if the terms of issuance so permit)

Much flows from this recognition. Under the UCC, the investor's rights are neither simply a derivative property interest of assets that happen to be held for customers, nor immune from dilution. As was just noted, an intermediary's duties include the obligation to maintain sufficient financial assets to cover the positions of its entitlement holders. A separate statutory section weight by providing:

"To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by

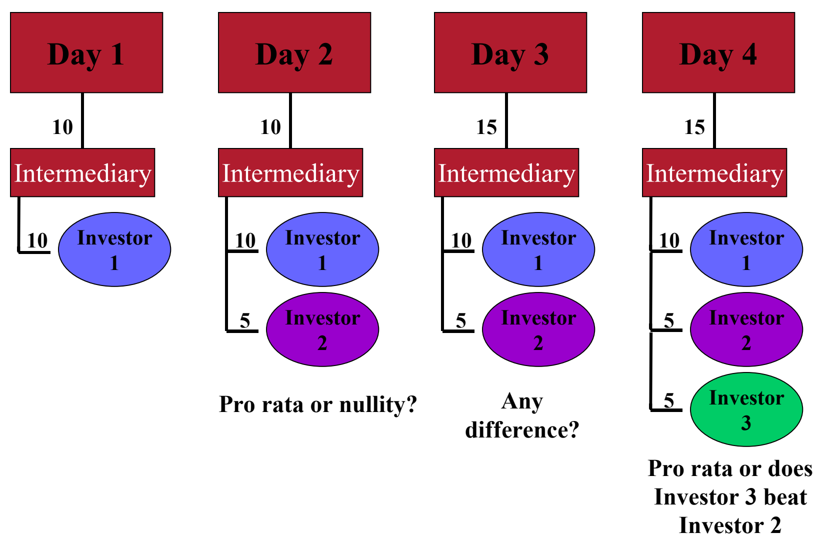
the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511". (Section 8-503(a))

Section 8-511 provides that in the event of a shortfall in financial assets, claims of entitlement holders have priority over claims of creditors other than secured creditors having control over the financial asset.



On the other hand, Section 503 goes on to provide

"An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the intermediary acquired the interest in that financial asset." (Section 8-503(b))



Under the UCC, on Day 2, the "overcrediting" would generally be effective and Investor 2 would be considered as obtaining a security entitlement, Investor 1's position being diluted. On Day 3 the intermediary would be in compliance with its obligations to both investors, and Day 4 would again involve dilution, not a "trumping" by last-in-time Investor 3.

Regarding this fact pattern: is the securities intermediary allowed to do this (over-credit)? It depends: if the action is fraudulent, no; in the U.S. if the position is created pending settlement and there is an open fail to receive, yes (for a limited period of time). (And of course we are not at this point addressing "mistaken" credits or debits.)

Recognizing a new concept of property interest in a security entitlement enables the prevention of "upper tier attachment" and itself enhances certain aspects of finality – both of which are essential to the smooth functioning of the markets. The intermediary that is maintaining the securities account for the investor is the only place the investor's attachable property resides. UCC Article 8 makes clear that the customer's interest cannot, except in very limited circumstances, be asserted against any other intermediary (or purchaser) – and modified a rule to clarify that a creditor can attach the customer's interest only at that level by process

against the intermediary (or, if a secured party had become the entitlement holder with respect to pledged assets, by process against the secured party). (This is sometimes referred to as a "no look through" approach.)

This also means that in the event of an intermediary's insolvency customers will share pro rata (financial asset category by category), and it seems to me that some method of loss sharing must be made explicit in conjunction with any recognition of the effects of holding securities through an intermediary. (In the U.S. for stockbrokers covered by the Securities Investor Protection Act, the sharing is done without regard to the type of financial asset – all customer property is pooled and shortfalls are allocated across financial asset categories.)

PRINCIPLE 3 – Provide enhanced finality.

The U.S. is certainly far from unique in recognizing the concept of a good faith or other type of protected purchaser, especially in the world of tangible movables. In such a case a rightful owner can be prevented from recovering wrongfully transferred property. But in the indirect system how is such a rule implemented? The asset is certainly far less traceable, but that doesn't answer the question. As someone once said, whoever controls the hypothetical controls the answer, so here is my hypothetical:

Two investors, one whose securities were improperly moved out by an intermediary and one who acquired a security entitlement in respect of those securities without notice that their transfer was improper. Putting the burden on the first feels unfair – and therefore there are some who might suggest that this plaintiff should enjoy the right to recapture. The question, however, is not really whether this plaintiff should have redress – of course she should. The question for the commercial law project is really whether the "innocent" (and we can debate the contours of innocence) transferee should be at risk. For the transferee to be at risk in any meaningful way of course presumes traceability, which is quite unlikely in the vast majority of cases. One might therefore feel comfortable supporting recapture rights under the theory that there will be few successful attempts anyway. On the other hand, in most cases the recipient has no idea where the purchased securities are coming from, and just the possibility of such a tracing or recapture right has been thought (and felt, through market experience) to constitute something of a cloud

on title. The potential ripple effect in the market of tracing wrongfully transferred securities through multiple purchasers could have negative consequences exponentially exceeding the benefit to the wronged original owner. For these reasons, the policy choice made in the UCC was to permit *any* purchaser – which term includes secured parties – who gives value (which in the U. S. means any sort of consideration) and obtains control without notice of a particular adverse claim to be protected against the assertion of that adverse claim. It is for that reason that I believe the better – and perhaps more honest – outcome is for commercial law to provide clear and widely available adverse claim cut-off rules, which promote systemic confidence and thus work to the benefit of investors large and small.

Another aspect of finality that is of vital concern to market participants is finality notwithstanding the insolvency of a transferor. Zero hour and other recapture rules have a chilling effect on the market and for that reason in the context of such an interlinked trading system should be eliminated or limited to the fullest extent possible. These negative insolvency effects have been questioned as a policy matter in many corners – including a major symposium sponsored some years back by the ECB. The long and tortured history of the appropriate contours for "safe harbors" under the key U.S. insolvency regimes – recently expanded yet again – illustrates this as well.

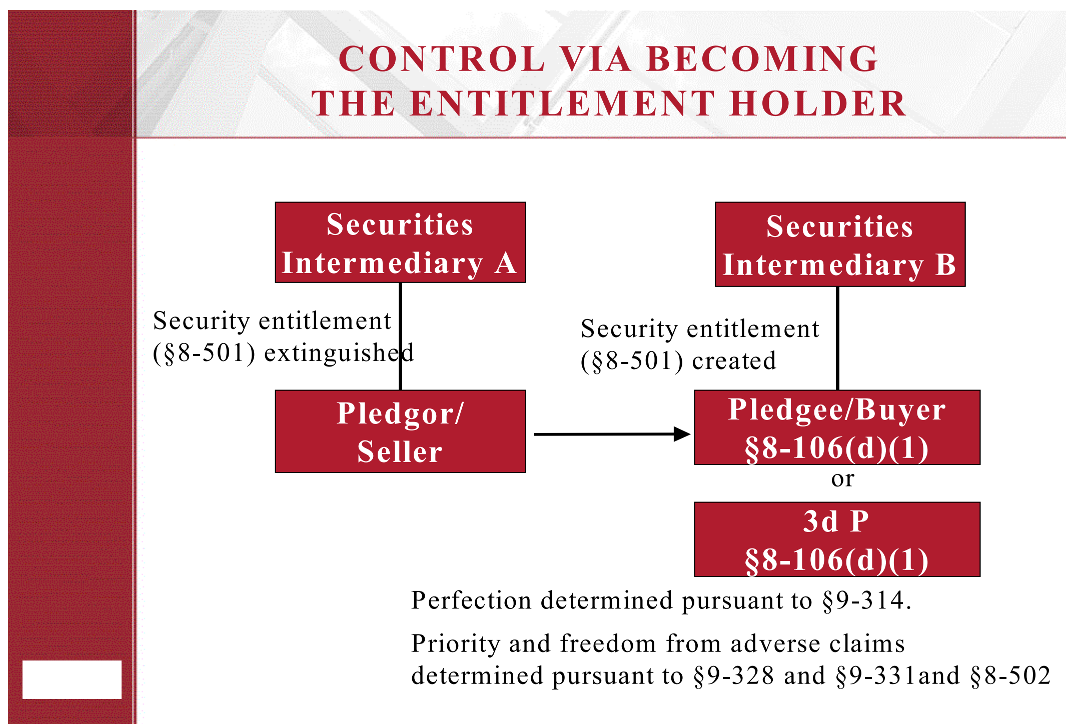
PRINCIPLE 4 – Provide a flexible approach to effectiveness, perfection and priority, including the reduction or elimination of formalities.

Flexibility was a recognized goal in two major respects: first, in terms of what the purchaser (especially a secured party) needs to do or have done in its favor; and second, what the pledgor can continue to do.

Since the issues requiring attention arose from the indirect system, the effectiveness of physical delivery of a security in certificated form remained undisturbed. But once the indirect system became recognized for what it is – a vast electronic grid in which securities and other financial assets are moved in response to transfer or other instructions – it seemed most efficacious to accommodate these realities of the marketplace in recognizing new

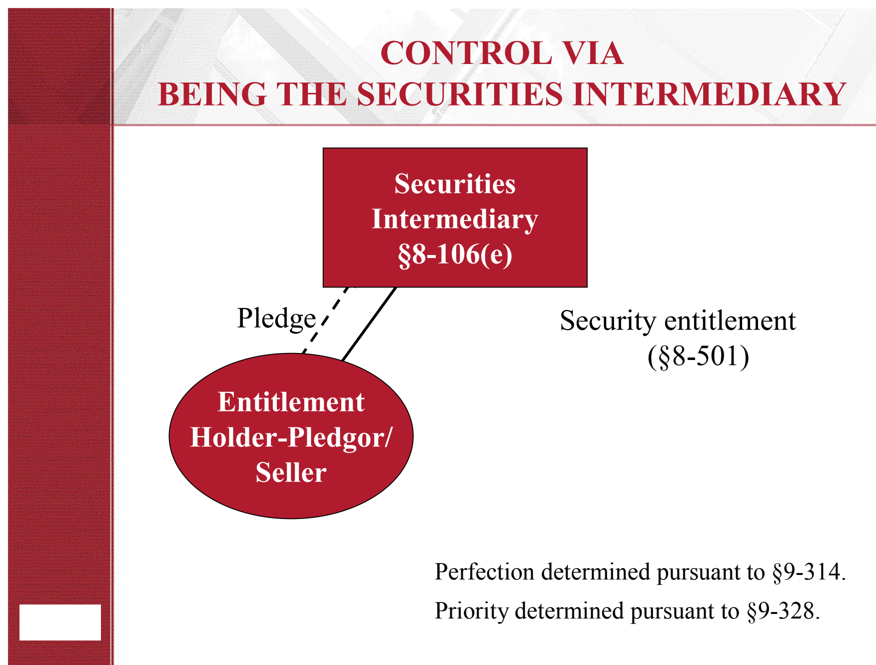
ways to effect transfers of interests. This meant not being limited to the ways one would typically transfer a physical certificate (e.g., physical delivery) or an intangible (e.g., notice to the obligor). In fairness, this did not begin with the development of the "security entitlement" concept – book entries had been recognized for quite some time, but not with the full panoply of attendant rights the market required.

In the U.S. the concept of control was introduced as a statutory construct: a transfer is perfected (i.e., enforceable against third parties) if the transferee has the right, enforceable against the intermediary, to direct the disposition of the subject assets. Such control can materialize in one of three types of situations. First, a transferee who has the financial assets credited to its own securities account is considered to be in control of the financial assets – and this is the one that involves a "book-entry" in the classic sense of a debit and corresponding credit:

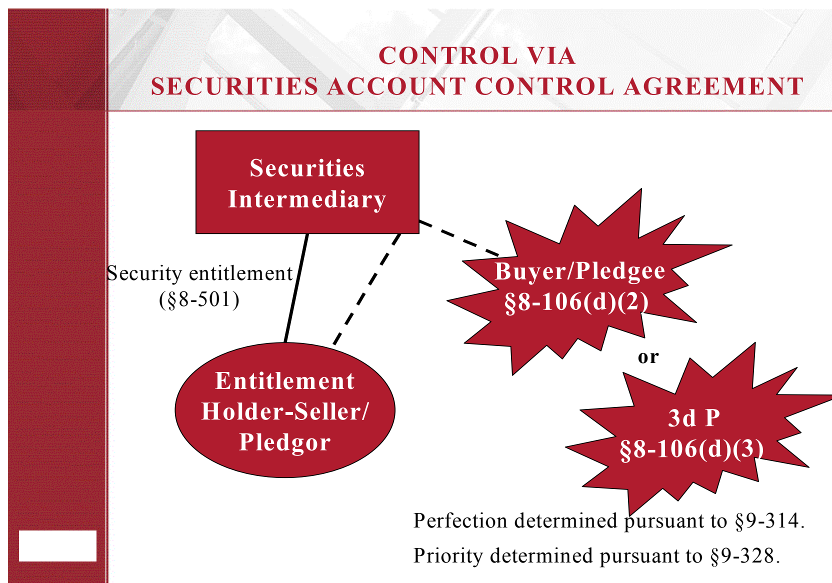


Second, the intermediary with which a securities account is maintained is considered, as a matter of law, to be in control of the financial assets carried in that securities account (note that no book-entry is needed in such a fact pattern – market participants are expected to assume that an "upper tier" intermediary, often involved in the clearing and

settlement of securities on behalf of its customers, would have a lien without making a notation on its books). The UCC includes a statutory lien in favor of such intermediaries as well – which arises in the circumstance in which the intermediary extends credit to the customer in connection with the acquisition of a financial asset and is limited in scope to a security interest in the particular asset securing the particular extension of credit. (Section 9-206)



And third, a transferee who obtains the agreement of the intermediary to act on the transferee's instructions without further consent of the transferor has obtained control (note that the UCC states explicitly that an intermediary is under no duty to enter into such an agreement and is prohibited from doing so without its customer's consent).



Again, this last one requires no "book-entry" and has proved enormously useful, including for individual investors.

Registration of any sort is not required (in the U.S. perfection by filing a UCC financing statement is an option, but this affords less priority). And a book-entry is not the only way to effect a transfer of an interest. There are other settings in which requiring a book-entry would seem inappropriate – net settlement systems do not make debits and credits for each movement of financial assets – that would defeat the whole purpose; gifts and inheritances, a bankruptcy trustee's assertion of jurisdiction over estate assets – all these are likely to need effectiveness notwithstanding the lack of a book-entry.

The second aspect I mentioned has to do with what the pledgor can continue to do with the property, i.e., permitting a pledgor to continue to deal with the property transferred (and here we're really talking about the security interest context, although other transaction forms could be involved).

The U.S. concept of control does not require exclusivity: thus a pledgor can continue to maintain its portfolios with existing intermediaries who may not wish to extend credit, and can continue to trade its portfolios of securities, including through direct instructions to the relevant intermediary, notwithstanding a secured party's parallel right to originate such instructions. The limits, if any, and the interplay of these rights are left to the parties' agreement.

The secured party may or may not be comfortable allowing debtor access, and the debtor may seek to limit the circumstances in which the secured party can take action, but effectiveness of a secured party's interest as against third parties remains intact.

PRINCIPAL 5 – Recognize a secured party's right to reuse collateral.

In the first place, the line between ownership and security interest is often blurred under the law of a single jurisdiction, and when the situation goes cross-border it only gets worse. This is where numbers are also typically mentioned: trillions of dollars in value are involved in the reuse of financial assets transferred under securities contracts, repurchase transactions and swap agreements – forming long chains of reuse. The U.S. has chosen to permit this explicitly whenever a secured party is in possession or control, while the U.K. (as I understand it) had traditionally required the form of transfer to be "outright" – at least in form – in order to accommodate this. (I believe the implementation of the EU Collateral Directive loosened this up somewhat.) In any event, reusing "collateral" is what the market *does*. If the U.S. experience is any guide, new commercial law approaches need to recognize this and permit it – hopefully in a way that does not elevate form over substance. (This does not mean that an intermediary is permitted to use fully paid customer securities, of course. In the United States this would generally require the customer's permission and in that case could be subject to various restrictions.)

This might be an appropriate moment for reiterating something I mentioned earlier: the UCC itself sits in a nest of other law and regulation – regulation and supervision that determine, among many other things, the right of an intermediary to use non-proprietary assets and the absence of such controls (or the infrastructure to support them) could militate in favor of commercial law adjustments.

PRINCIPLE 6 – Provide flexible realization rules, including self-help.

In the U.S. a secured party has the right as a matter of law to dispose of property in which it has a security interest after default, but the secured party's actions must be commercially reasonable. For commonly traded financial assets prompt collateral liquidation without the need for any sort of judicial intervention is one of the hallmarks of the type of commercial law rule this market requires. The limited commercial law interference with using self help to realize on marketable and fungible collateral reduces the likelihood of gridlock and the systemic risk that could ensue.

PRINCIPLE 7 – Provide special protections for intermediaries where warranted

Three circumstances come immediately to mind here - the first is allowing special deference to the rules of regulated/supervised clearing organizations and central counterparties. (This principle is recognized in the EU Settlement Finality Directive, as I am sure you are aware.) These entities or systems are key players in the smooth flow of securities trading and settlement and generally do not (are not permitted to) maintain true proprietary positions. In the U.S. the concept of "clearing corporation" is limited to

(i) a person that is registered as a "clearing agency" under the federal securities laws;

(ii) a federal reserve bank; or

(iii) any other person that provides clearance or settlement services with respect to financial assets that would require it to register as a clearing agency under the federal securities laws but for an exclusion or exemption from the registration requirement, if its activities as a clearing corporation, including promulgation of the rules, are subject to regulation by a federal or state governmental authority.

Although this category has been expanded somewhat over the years it is still a fairly small club. Because of the important role played by these institutions and the nature and extent of their supervision (at least in the U.S.), the UCC includes special rules just for clearing corporations.

One is found in UCC Section 8-111, which provides "A rule adopted by a clearing corporation governing rights and obligations among the clearing corporation and its participants in the clearing corporation is effective even if the rule conflicts with this [Act] and affects another party who does not consent to the rule." This section provides essential comfort to clearing organizations that the various loss sharing, finality and failed-settlement rules they adopt will be given effect irrespective of what Article 8 would otherwise mandate.

Another allows a departure from the usual relationship between a securities intermediary's customers and its creditors. As I mentioned earlier, creditors without control are generally subordinated to customers, and secured creditors having control are superior. In the clearing corporation context, however, requiring the secured creditors – in practice limited to liquidity lines to provide end of day failed-settlement financing - to obtain control (which would require reregistration or possession of certificates or control agreements with issuers) could be disruptive to ordinary securities processing if put in place at the outset and impossible to accomplish in a timely manner if only put in place when an end-of-day loan was required. Given this special situation, the UCC provides, under Section 8-511(c), that all creditors of clearing corporations have priority over customers.

The third circumstance is an adjustment to the rules governing when interests in securities held indirectly are acquired free of adverse claims.

Section 8-115 of the UCC (Securities Intermediary and Others Not Liable to Adverse Claimant) provides:

"A securities intermediary that has transferred a financial asset pursuant to an effective entitlement order, or a broker or other agent or bailee that has dealt with a financial asset at the direction of its customer or principal, is not liable to a person having an adverse claim to the financial asset, unless the securities intermediary, or broker or other agent or bailee:

(1) took the action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order, or other legal process; or

(2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or

(3) in the case of a security certificate that has been stolen, acted with notice of the adverse claim."

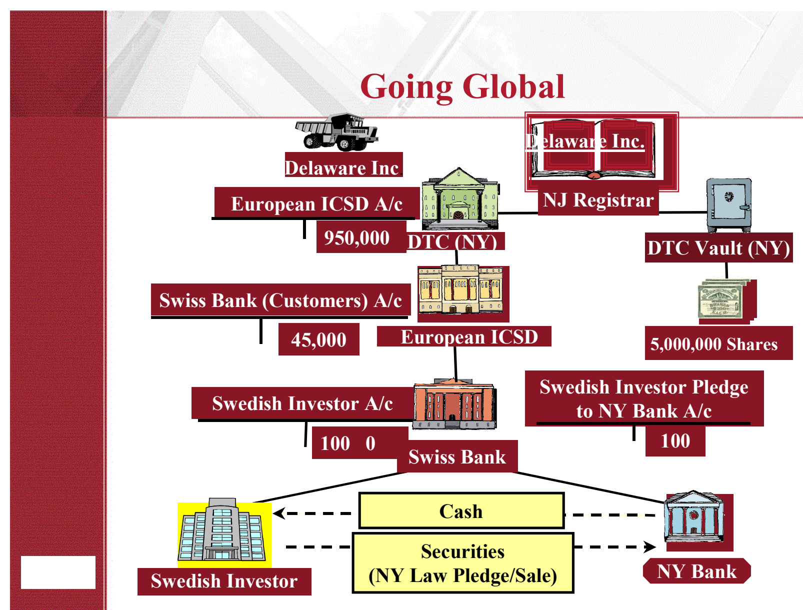
This standard, applicable to any securities intermediary, recognizes the "conduit" nature of the intermediary's role and does not attribute the knowledge or wrongful behavior of customers or counterparties to the intermediary.

PRINCIPLE 8 – Provide clear and market-sensitive choice of law rules.

A preliminary note is in order: the ensuing discussion has to do with rights in or to securities or other financial assets held through interermediaries but does not address the relationship of parties to a transaction or the relationship between account holder and intermediary as a contract law matter.

Before the last round of UCC revisions, it would have been fair to say that while the UCC provided clear choice of law rules, the rules were limited in reach (essentially applied only to secured transactions) and not market sensitive. They were clear because the rule turned on whether the security was in certificated form – in which case the physical location of the certificate was key, or uncertificated, in which case the jurisdiction in which the issuer was organized was determinative. (This was particularly counter-intuitive when applied to the U.S. Treasury (and U.S. agency) securities that the federal regulations had "deemed" to be maintained in bearer definition form "at a Federal Reserve Bank".)

But as for reach and market sensitivity – again an illustration will be illuminating:



In this fact pattern – or in any fact pattern involving indirect holding – participants needed to know what law governed their rights against others, known and unknown. This includes the counterparty to a given sale or pledge transaction (and its insolvency representative), the intermediary or intermediaries with which the parties dealt, other entities involved in the transfer and holding of the relevant assets and competing claimants of all sorts. And the answer needed to make sense – not point to a jurisdiction with no discernibly relevant relationship to the rights and interests being determined (e.g., the Delaware jurisdiction of organization or the N.Y. vault, in the picture above).

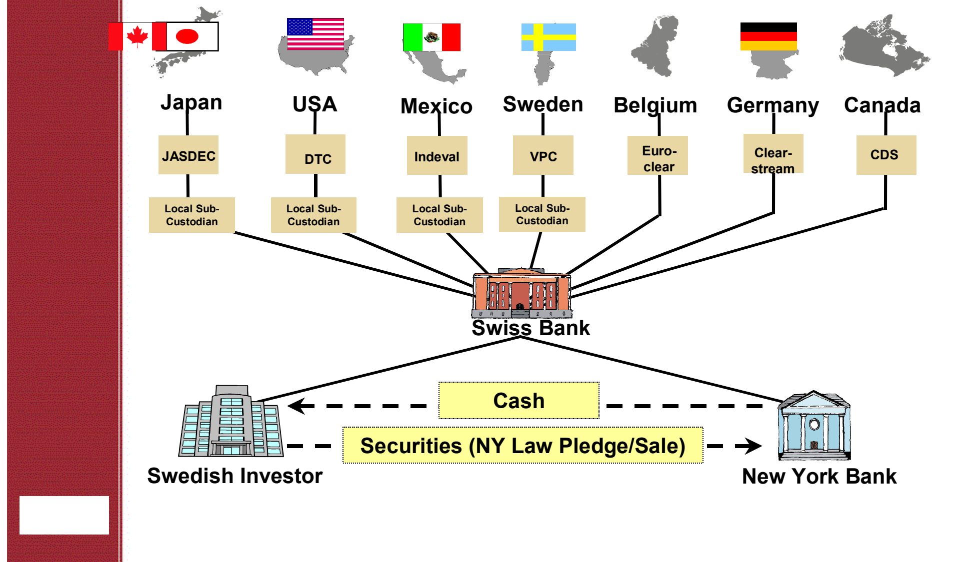
The U.S. response was to take an unprecedented path: the concept of "securities intermediary's jurisdiction" was developed. In general terms, the law governing the rights one acquired via a credit to one's securities account, the whether an adverse claim could be asserted against a purchaser, perfection in most circumstances and priority of a security interest, is the law of the "securities intermediary's jurisdiction". This concept is not entirely intuitive, and has definitely taken some getting used to (especially for non-U.S. practitioners). It is worth summarizing the way in which the relevant law is determined:

UCC Section 8-110(e) Applicable Law

The following rules determine a "securities intermediary's jurisdiction":

- An express selection of a "securities intermediary's jurisdiction in the relevant agreement between the securities intermediary and its entitlement holder.
- An express selection of a governing law in the relevant agreement between the securities intermediary and its entitlement holder.
- An express provision in the relevant agreement between the securities intermediary and its entitlement holder that the securities account is maintained at an office in a particular jurisdiction.
- The jurisdiction in which the office identified in an account statement as the office serving the entitlement holder's account is located.
- The jurisdiction in which the chief executive office of the securities intermediary is located.

Keeping this U.S. shift in mind – from the location of the security certificate or the jurisdiction of organization of the issuer to the "securities intermediary's jurisdiction, we see that in the prior slide the relevant law will be determined in some way by reference to the Swiss Bank. Whether Swiss law will in fact apply or what Swiss law has to say (substantively) are beyond the scope of my talk. But focusing on the choice of law, we've now eliminated several other jurisdictions (e.g., location of certificate, jurisdiction of issuer's organization, location of securities register, pledgor's or seller's location, jurisdictions relevant to other intermediaries). Think of the possibilities when you look at how a diversified portfolio might look:



I can't think of a better way – or a better moment – to turn things over to the extraordinary Dr. Christophe Bernasconi and The Hague Securities Convention

Thank you very much.

October 27, 2006