

**Memorandum Regarding the Uniform Version
of Article 8 of the Uniform Commercial Code
and the Treatment of Investment Property
Under the Uniform Version of Article 9**

Comment: THIS DOCUMENT
SUPERSEDES IMANAGE #892805

**with Addenda Regarding
Federal Book-Entry Regulations and International Developments**

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I. INTRODUCTION AND BACKGROUND

The Uniform Commercial Code (the “UCC”), a product of joint efforts by the American Law Institute (“ALI”) and the National Conference of Commissioners on Uniform State Laws (“NCCUSL”), consists of eleven articles, the first of which sets forth certain general provisions and the second through eleventh of which provides rules for various types of commercial practices. Article 8 governs investment securities and Article 9 governs security interests in personal property. This set of uniform laws, which is periodically revised to respond to developments in the law and commercial practice, has no effect until adopted by the relevant legislative body. In 1994 the ALI and NCCUSL approved a major revision of Article 8, and in 2001 a major revision of Article 9. In each case conforming amendments were made to other articles. Revision of the prior version of Article 8 of the UCC had been urged for several years, and the revisions were considered to represent a major advance in commercial law, particularly in addressing computerized recordkeeping and global securities trading. Similarly, revisions to Article 9 were widely supported. The uniform version of Article 8 is in effect in all fifty States and the District of Columbia and Puerto Rico, and with certain exceptions not relevant to this memorandum, the uniform version of Article 9 insofar as it applies to investment property is also in effect in all fifty States and the District of Columbia.¹

The prior version of Article 8 had assumed the evolution of a system in which issuers would no longer issue certificates.² Hence, parallel provisions dealing with uncertificated securities were established. Both the certificated and uncertificated provisions of the 1978 amendments contemplated that the beneficial owners of securities would often have a direct relationship with the issuer of the securities, either by being the holder of a bearer instrument and thus having a direct claim against the issuer or by, in the case of registered securities, being recorded as the owner on the records maintained by the issuer or its transfer agent.³ Other than in the case of mutual fund shares, however, a system of uncertificated securities did not develop. An extensive pattern of indirect holding developed instead. Certificates are still issued but tend not to be in the hands of the ultimate beneficial owners. The securities are registered in the name of, and immobilized with, clearing corporations and other depositories. The depository’s books in turn show the identity of the banks or brokers that are its members, and the records of those intermediaries identify their customers. (See Diagram 1)

The prior version also included outdated choice of law rules, based in large part on where a physical security certificate was located, which often resulted in the application of the law of a jurisdiction that most market participants considered irrelevant. The UCC now provides choice-of-law rules in both the sale and security interest contexts that are keyed to the way in which the interest in the security is maintained.

¹ See www.ali.org and www.nccusl.org for more information on these bodies and their work.

² Prefatory Note to Article 8, at 2.

³ Prefatory Note to Article 8, at 4.

The version of Article 8 now in effect was thus the result of the effort to overhaul current commercial law rules for investment securities to reflect the realities of modern securities holding practices. The revisions have also expanded the types of assets covered and deal directly with the nature of the property interest obtained by a purchaser of securities and other financial assets in the indirect holding system.

The UCC has therefore moved from an approach based on an attribute of the security itself (certificated vs. uncertificated), and reflects instead a distinction based on how the security is held. Under Article 8, the most significant distinction is whether one has a “direct” relationship with the issuer, as when one is a “record owner,” or an “indirect” relationship, as when the investment is held through one or more intermediaries. Because the differences between the systems of direct and indirect holding are significant, the drafters determined that it would be better to treat them as separate systems requiring different legal concepts.⁴ Article 8 classifies the system in which the owner has a direct relationship with the issuer as the “direct holding system;” the rules for this system (set out in Part 3 of the statute) apply only to securities, not a broader category of financial assets. The system in which interests in financial assets, including securities, are held through one or more intermediaries is classified as the “indirect holding system.” Of course, the indirect system is not entirely independent of the direct system - in the case of securities, the entity at the top of the indirect chain will have a “direct” relationship with the issuer itself.⁵

The recently adopted (and enacted) revisions to Article 9 brought along few substantive revisions to the treatment of investment property as collateral, and for the most part simply integrated the investment property provisions (that had been contained in a single section) into the revamped structure of the Article.⁶

II. SELECTED TERMINOLOGY

Certain terminology in the UCC is critical to a basic understanding of the relationship between the indirect and direct holding systems and the various relationships among parties having interests in securities and financial assets. Set forth below are some of the key terms.

⁴ Prefatory Note to Article 8, at 6.

⁵ For various securities issued by the United States Treasury and other agencies and government sponsored organizations which are maintained in the form of entries in the records of Federal Reserve Banks, a system of federal regulation (commonly referred to as the “TRADES Regulations”) intersects with the UCC. This memorandum will not deal directly with these regulations except to note that the issuer’s obligations are governed by federal law and specific choice of law rules paralleling those in the UCC ensure that in other respects the UCC as in effect in the relevant state applies to these securities as well. See, e.g., 31 C.F.R. pt. 357 (later publications confirm that the limited, transitional preemptive effect of these regulations is no longer in effect). Information regarding these regulations may be found on the website of the United States Treasury’s Bureau of Public Debt (www.publicdebt.treas.gov/cc/cctrades.htm).

⁶ The revisions did make some substantive changes, however, including refinements of the priority and choice of law rules, which are reflected in the summary provided below.

As a preliminary matter, it is important to note that the term “purchaser” is used in the UCC to include a person who takes by any voluntary transaction creating an interest in property – including sale, security interest, issuance and gift, among other methods. See Sections 1-201(32),(33).⁷

The term “Control” means that a purchaser (which term includes secured parties as well as buyers) has taken whatever steps are necessary, given the manner in which assets are held, to place itself in a position where it can have the assets sold, without further action by the original owner. Official Comment 1, Section 8-106.

- Control of bearer securities is obtained by delivery. Section 8-106(a).
- Control of certificated securities in registered form requires delivery as well as either effective indorsement to the purchaser or in blank (Section 8-106(b)(1)) or registration of transfer by the issuer (Section 8-106(b)(2)).
- Control of uncertificated securities requires delivery (Section 8-106(c)(1)) or obtaining an agreement pursuant to which the issuer agrees to act on instructions from the purchaser without further consent from the registered owner (Section 8-106(c)(2)).
- Control of security entitlements occurs when the purchaser becomes the entitlement holder itself or if it obtains the agreement of the securities intermediary and the entitlement holder to comply with instructions of the purchaser, without further consent by the entitlement holder. Section 8-106(d). The statute also specifically recognizes that an entitlement holder’s own securities intermediary has control over the security entitlement of the entitlement holder. Section 8-106(e).

The statute makes clear that control can be obtained directly by a purchaser or through another person acting on behalf of the purchaser.

The term “Delivery” is defined in Section 8-301 depending on the form in which the security is held.

- Delivery of certificated securities occurs (a) when a purchaser acquires possession of a security certificate or (b) a person (other than a securities intermediary) acquires possession of the certificate on behalf of the purchaser or, if having previously acquired possession, acknowledges that the certificate is held for the purchaser. Section 8-301(a)(1) and (a)(2). If a securities intermediary is involved, the certificate must be in registered form and may not be indorsed to the intermediary or in blank (when held by an intermediary a bearer security or a security so indorsed would be considered part of the indirect system).

⁷ Article 1 of the UCC has been revised, but very few states have enacted it to date and therefore references in this memorandum to sections of Article 1 and to the version currently in effect in the State of New York.

- Delivery of uncertificated securities occurs when (a) the issuer registers the purchaser as the registered owner or (b) a person (other than a securities intermediary) becomes the registered owner thereof on behalf of the purchaser or, if having previously become the registered owner, acknowledges that it holds for the purchaser. Section 8-301(b).

The term “Adverse claim” is defined in Section 8-102(a)(1) as “a claim that the claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset.” The term refers only to property interests and requires that the claimant’s property interest be violated by another person’s holding or transferring of the security (or other financial asset). The term clarifies an ambiguity in Section 8-302 of the prior version of Article 8 that suggested that any wrongful action concerning a security, including a simple breach of contract, gave rise to an adverse claim. See Fallon v. Wall Street Clearing Corp., 586 N.Y.S.2d 953, 182 A.D.2d 245 (1992) and Pentech Intl. v Wall St. Clearing Co., 983 F.2d 441 (2d Cir. 1993) (which decisions were based on this broader view and are rejected by the new definition). The term is not limited to ownership rights but also covers security interests and other property interests established by law.

The concept of “Notice of adverse claim” is defined in Section 8-105 to be actual notice or willful blindness.⁸ A person will be charged with notice of an adverse claim if the purchaser “has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.” Section 8-105(a)(3).

The term “Value” is defined in Section 1-201(44) includes, inter alia, any consideration sufficient to support a simple contract (including, e.g., past extensions of credit).

The term “Collusion” is not defined in the statute but is stated to be “intended to adopt a standard akin to the tort rules that determine whether a person is liable as an aider or abettor for the tortious conduct of a third party.” Official Comment, Section 8-115 (citing Restatement (Second) of Torts § 876).

The term “Security entitlement” is defined in Section 8-102(a)(17) as the “rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5,” discussed in Part IV below.

The term “Securities account” is defined in Section 8-501(a) as “an account to which a financial asset is or may be credited in accordance with an agreement under which the

⁸ Specifically, Section 8-105 provides that “the person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim.”