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## Father Knows Best: Revised Article 8 and the Individual Investor

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# FLORIDA STATE UNIVERSITY LAW REVIEW



FATHER KNOWS BEST:  
REVISED ARTICLE 8 AND THE INDIVIDUAL INVESTOR

*Francis J. Facciolo*

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# FATHER KNOWS BEST: REVISED ARTICLE 8 AND THE INDIVIDUAL INVESTOR

FRANCIS J. FACCIOLO\*

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## I. INTRODUCTION

Most states, including New York State,<sup>1</sup> have adopted a major revision of Article 8 of the Uniform Commercial Code (Revised Article 8), along with related amendments to Article 9 (Revised Article 9).<sup>2</sup> The Department of the Treasury has also adopted Revised Article 8 for the market in Treasury securities, preempting certain provisions of the laws of any state that has not adopted Revised Article 8.<sup>3</sup> In 1994, the adoption of Revised Article 8 by both the American Law Institute (ALI) and the National Conference of Commissioners of Uni-

1. See Uniform Commercial Code-Investment Securities, 1997 N.Y. LAWS 566. Governor Pataki signed New York's version of Revised Article 8, A. 6619-C, 220th Leg. (N.Y. 1996), on September 10, 1997. See *Pataki Signs Bill Clarifying N.Y. Law Dealing with Transfer of Securities*, 29 SEC. REG. & L. REP. (BNA) 1302 (Sept. 19, 1997). New York's version of Revised Article 8 took effect on October 10, 1997. See 1997 N.Y. LAWS 566, § 29.

2. As of June 1999, Revised Article 8 had been adopted by forty-eight states, the District of Columbia, and Puerto Rico. See *State U.C.C. Variations*, U.C.C. Rep. Serv. (West) xxi-xxii. A handful of states have enacted Revised Article 8 with material modifications, notably Connecticut and Delaware. Connecticut omitted revised section 8-511(b). See *id.* at 4. For further discussion of revised section 8-511(b) see *infra* text accompanying notes 277-86 for a discussion of revised section 8-511(b).

Delaware has carved out of revised sections 8-112(a) and (b) its fictitious "situs [in Delaware] of the ownership of the capital stock" of all Delaware corporations, DEL. CODE ANN. tit. 8, § 169 (Supp. 1991), and its attachment provisions for shares and options or a "right or interest" therein, *id.* § 324; see also *State U.C.C. Variations, supra*, at 4.

Revised Sections 8-112(a) and (b) are meant to restrict legal process on certificated securities to "actual seizure of the security certificate," and on uncertificated securities to "legal process upon the issuer at its chief executive office in the United States." A.L.I. & NCCUSL, 1994 OFFICIAL TEXT WITH COMMENTS [hereinafter 1994 OFFICIAL TEXT] §§ 8-112(a), (b) (1994). When a secured party has a certificated security in its "possession," registration of an uncertificated security "registered" to it in "or a security entitlement maintained in" its name, then legal process may be on the secured party. *Id.* § 8-112(d). Delaware does not require seizure of certificated securities or legal process upon the issuer of uncertificated securities for an effective attachment. See DEL. CODE ANN. tit. 8, § 324(a) (Supp. 1991).

In addition, California enacted the text of Revised Article 8 without material modifications although the Consumers Union had sought changes. See Letter from Gail Hillebrand to Bion Gregory, Legislative Counsel (Nov. 25, 1996) (on file with author). The Consumers Union withdrew its opposition when changes were made to the Official Comments to revised sections 8-101, 8-504 and 8-509. See CAL. COM. CODE §§ 8101 cmt., 8504 cmt. 4, 8509 cmt. (West 1997). Particularly important were the changes to the Official Comments to revised section 8-504, which seek to clarify what constitutes a securities intermediary's "obligation of good faith performance." *Id.* § 8504 cmt. 4. In addition, section 1799.103 was added to the California Civil Code to protect individual investors by providing that a "consumer credit contract or guarantee of a consumer credit contract" cannot create a "security interest in any investment property . . . unless (a) the contract either specifically identifies the investment properly as collateral or (b) the secured party is a securities intermediary." *Id.* § 1799.103.

3. See Regulations Governing Book-Entry Treasury Bonds, Notes and Bills (Aug. 23, 1996), 61 Fed. Reg. 43,626 (1996) (codified at 31 C.F.R. pt. 357). Similar rules have been adopted by the other "government sponsored enterprises that issue securities maintained on the Federal Reserve Bank . . . System." Robert A. Wittie, *Review of Recent Developments in U.C.C. Article 8 and Investment Securities*, 52 BUS. LAW. 1575, 1576 (1997) (listing the enterprises and their regulations). This Article will not discuss any of these regulations in any detail.

form State Laws (NCCUSL)<sup>4</sup> was the culmination of a process that began in 1988.<sup>5</sup> Although the supporters of Revised Article 8 have stoutly maintained that it is primarily a clarification of 1977 Article 8 and that the proposed changes are insignificant, Revised Article 8 actually includes major changes that should be of concern to all individual investors in America's securities markets. Without significant amendments to certain sections of Revised Article 8, individual investors will be profoundly disadvantaged.

This Article uses New York State<sup>6</sup> to test the validity of the arguments made for Revised Article 8, in part, because New York City is the national center of the securities industry. Revised Article 8 clarifies the conflict of laws rules as compared to those in 1977 Articles 8 and 9.<sup>7</sup> When dealing with securities entitlements, which are described below, New York law would be relevant either because choice of law provisions in contracts drafted by securities intermediaries normally specify New York law<sup>8</sup> or because the chief executive office of most major securities intermediaries is located in New York.<sup>9</sup> The amount of written material generated in support of adopting Revised Article 8 in New York, which is greater than in other states, also makes New York a useful test case.<sup>10</sup>

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4. See *Revised Article 8: Investment Securities*, in 1994 OFFICIAL TEXT, *supra* note 2.

Article 8 has undergone a number of revisions since it was first adopted in 1952. This Article refers primarily to two official texts other than the 1994 OFFICIAL TEXT: Revised (1977) Article 8 of the Uniform Commercial Code, 2C U.L.A. 267-511 (1997) [hereinafter 1977 OFFICIAL TEXT]; and Article 8 [Pre-1977 Version], 2C U.L.A. 513-579 (1997) [hereinafter 1962 OFFICIAL TEXT]. The versions of Article 8 embodied in the 1962 OFFICIAL TEXT and the 1977 OFFICIAL TEXT will be referred to in this Article as 1962 Article 8 and 1977 Article 8, respectively.

5. See INTERIM REPORT OF THE ADVISORY COMMITTEE ON SETTLEMENT OF MARKET TRANSACTIONS: EXPOSURE DRAFT FOR COMMENT, 1991 A.B.A. SEC. BUS. L. 1 [hereinafter 1991 ABA REPORT].

6. In New York State, the Article 8 in force until October 9, 1997 (1977 New York Article 8), was based on the ALI's April 1977 version rather than the final official text adopted by the ALI and NCCUSL. This history means that there are a number of inadvertent, nonuniform provisions in 1977 New York Article 8. See COMMITTEE ON THE UNIFORM STATE LAWS AND THE BANKING LAW COMMITTEE, ASSOCIATION OF THE BAR OF THE CITY OF N.Y., REPORT ON PROPOSED REVISIONS TO ARTICLE 8 OF THE NEW YORK UNIFORM COMMERCIAL CODE, WITH CONFORMING AND MISCELLANEOUS AMENDMENTS TO ARTICLES 1, 5, 9 AND 13 THEREOF AS WELL AS CONFORMING AND MISCELLANEOUS AMENDMENTS TO OTHER STATUTES 66 (Feb. 21, 1996) [hereinafter ARTICLE 8 BAR REPORT].

This Article also refers to the 1962 version of Article 8, as adopted in New York State. See U.C.C., 1962 N.Y. LAWS 553 [hereinafter 1962 New York Article 8].

7. For a discussion of the conflict of law problems that Revised Article 8 attempts to solve, see James S. Rogers, *Policy Perspectives on Revised UCC Article 8*, 43 UCLA L. REV. 1431, 1457-60 (1996).

8. See 71 A.L.I. PROC. 224 (1994).

9. Section 8-110(e)(4), 1994 OFFICIAL TEXT, *supra* note 2, provides that the default rule for determining a securities intermediary's jurisdiction is to use "the jurisdiction in which is located the chief executive office of the securities intermediary."

10. See, e.g., ARTICLE 8 BAR REPORT, *supra* note 6; Randall D. Guynn, *Revised Article 8 of the UCC: Preserving New York as a Leading International Financial Center*, N.Y. ST.

In addition, this Article functions as a case study of the relative impact of industry groups and consumers, referred to in this article as “individual investors,” on the UCC revision process. Recently, a great deal has been written criticizing the revision process both for its procedures<sup>11</sup> and for the substantive proposals generated by these procedures.<sup>12</sup> Professor Edward L. Rubin has been one of the most eloquent of these critics, combining a mastery of UCC Articles 3 and with an insider’s view of what occurred during the recent revision process of these two Articles.<sup>13</sup> The revision process, however, has also attracted its defenders.<sup>14</sup> This is, of course, not a new debate.<sup>15</sup>

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B.J., Mar./Apr. 1996, at 8; Richard B. Smith & Paul M. Shupack, *New York Needs a Revised Article 8*, N.Y. L.J., May 30, 1996, at 1.

11. Most written work touches on both procedural and substantive aspects. Some work, however, is more concerned with the process of revision than with the content of the actual proposals. See, e.g., Kathleen Patchel, *Interest Group Politics, Federalism and the Uniform Law Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83 (1993); Donald J. Rapson, *Who Is Looking Out for the Public Interest? Thoughts About the U.C.C. Revision Process in the Light (and Shadows) of Professor Rubin’s Observations*, 28 LOY. L.A. L. REV. 249 (1994); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995); Harry C. Sigman, *Improving the U.C.C. Revision Process: Two Specific Proposals*, 28 LOY. L.A. L. REV. 325 (1994); Norman I. Silber, *Substance Abuse at U.C.C. Drafting Sessions*, 75 WASH. U. L.Q. 225 (1997). For a neutral set of proposals concerning the revision process, see Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909 (1995).

12. For those written works more concerned with content, see, e.g., Mark E. Budnitz, *The Revision of U.C.C. Articles Three and Four: A Process Which Excluded Consumer Protection Requires Federal Action*, 43 MERCER L. REV. 827 (1992); Nan S. Ellis & Steven B. Dow, *Banks and Their Customers Under the Revisions to Uniform Commercial Code Articles 3 and 4: Allocation of Losses Resulting From Forged Drawers’ Signatures*, 25 LOY. L.A. L. REV. 57 (1991); Gail Hillebrand, *The Redrafting of U.C.C. Articles 2 and 9: Model Codes or Model Dinosaurs?*, 28 LOY. L.A. L. REV. 191 (1994); Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B and 9 Be Fair to Consumers?*, 75 WASH. U. L.Q. 69 (1997) [hereinafter Hillebrand, *The Uniform Code Drafting Process*]; Cem Kaner, *Proposed Article 2B; Problems from the Customer’s View* (pts. 1 & 2), U.C.C. BULLETIN, Jan. 1997, at 1, U.C.C. BULLETIN, Feb. 1997, at 1. Cf. Margaret L. Moses, *Look Before Leaping to Adopt Revised Article 5*, N.J. L.J., Jan. 1, 1996, at 12 (describing the detrimental impact of certain provisions of revised Article 5 on New Jersey companies that use letters of credit).

13. For Professor Rubin’s comments on the revision process, see Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising U.C.C. Articles 3 and 4*, 26 LOY. L.A. L. REV. 743 (1993) [hereinafter Rubin, *Thinking Like a Lawyer*]. For his more general comments on consumers’ abilities to enforce their rights under the UCC, see Edward L. Rubin, *The Code, the Consumer, and the Institutional Structure of the Common Law*, 75 WASH. U. L.Q. 11 (1997) [hereinafter Rubin, *The Code, the Consumer*]. For his often critical comments on revised Article 3 and 4, see Edward L. Rubin, *Efficiency, Equity and the Proposed Revision of Articles 3 and 4*, 42 ALA. L. REV. 551 (1991). See generally Edward L. Rubin, *Policies and Issues in the Proposed Revision of Articles 3 and 4 of the U.C.C.*, 43 BUS. LAW. 621 (1988) (attempting to describe policy choices made by early drafts of revised Articles 3 and 4 without taking a position on these choices).

14. See, e.g., Fred H. Miller, *The Future of Uniform State Legislation in the Private Law Area*, 79 MINN. L. REV. 861 (1995); A. Brooke Overby, *Modeling U.C.C. Drafting*, 29 LOY. L.A. L. REV. 645 (1996); Carlyle C. Ring, Jr., *The U.C.C. Process-Consensus and Balance*, 28 LOY. L.A. L. REV. 287 (1994).

Practicing attorneys from major law firms dominated the revision process that led to Revised Article 8. These law firms, in turn, have major clients in the broker-dealer and banking industries.<sup>16</sup> The Securities and Exchange Commission (SEC) and the Federal Reserve Board also played major roles. These federal agencies, however, are not satisfactory surrogate representatives of individual investors. This Article focuses on the SEC in examining whether the history of the relationships between these federal agencies and their regulated industries supports the view that individual investors, in fact, were adequately represented.<sup>17</sup>

A handful of academics, most notably Professor James S. Rogers, the reporter for Revised Article 8, played a role in the revision process.<sup>18</sup> Professor Rogers has claimed that there was no need for designated representatives of individual investors because many lawyers involved were “generalists” who “studied and commented upon drafts” and “whose natural inclination was to examine each issue from the perspective of any possible impact on their own interests as investors.”<sup>19</sup> As this Author does not share Professor Rogers’ further conclusion “that there is nothing in Revised Article 8 that is adverse to the interests of individual investors,”<sup>20</sup> this Author takes little comfort from the fact that attorneys, who did not see their role as one of representing individual investors and who often lacked the expertise to properly evaluate Revised Article 8, commented on the proposal.

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15. See, e.g., Frederick K. Beutel, *The Proposed Uniform[?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334 (1952). Although he wrote an influential article in response to Professor Beutel defending many provisions of the UCC, Professor Grant Gilmore did not defend Article 4. See Grant Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 377 (1952).

16. See *infra* text accompanying notes 473-80.

17. See *infra* Part X.

18. Lest the reader think that academics can substitute for committed consumer representatives, the following commentary on the value that the legal academy places on UCC scholarship should be heeded:

[S]ome of Doe’s [a mythical-professor’s] friends warned him that colleagues do not consider prodigious efforts on bar committees or at drafting sessions to be much of an indication of professional accomplishment for the purposes of evaluating his qualifications for tenure or for merit pay increases. They also cautioned him that publications in this area were likely to be treated as narrow, no matter how broad their significance; and that in all probability, writings about the Code would be harder to place in the major journals; more likely to go unread; and in general, be more easily dismissed and misunderstood by those who do not teach in closely related fields

Silber, *supra* note 11, at 225 n.3. Accord Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181, 198 (1996).

19. Rogers, *supra* note 7, at 1544-45.

20. *Id.* at 1545.

This Article suggests that consumer representatives need to be involved in the UCC revision process in a meaningful way.<sup>21</sup> Writing to groups that represent consumers<sup>22</sup> is a necessary, but insufficient, measure to encourage consumer involvement. As this Author is well aware from having written on Revised Article 8, an understanding of the issues raised by revisions involves studying a number of complex and interrelated areas of law. For example, to make an assessment of Revised Article 8, one must, at a minimum, evaluate economic studies of systemic risk in general and of clearance and settlement of securities trades in particular;<sup>23</sup> the Securities Investor Protection Act, the federal scheme that provides some protection resembling insurance to individual investors;<sup>24</sup> and the SEC's regulatory regime to protect individual investors, particularly the net capital, hypothecation and segregation (of customers' securities and cash) rules.<sup>25</sup> Furthermore, Revised Article 8 itself, although much more clearly conceptualized and drafted than prior versions, is hardly a relaxing read. Faced with such recondite and complex issues, what consumer representative will invest the hundreds, if not thousands, of hours necessary to understanding these disparate but related areas of law? Many other legal battlefields exist where the legal issues facing consumers are most familiar to lawyers, and where there is a history of pro-consumer commentary and activism.<sup>26</sup> Given the limited financial and human resources of legal groups representing consumers,<sup>27</sup> it is not surprising that Revised Article 8 attracted little commentary.

Funding is needed for consumer representatives to participate in the revision process.<sup>28</sup> These consumer representatives must partici-

21. Cf. Rubin, *The Code, the Consumer*, *supra* note 13, at 13 (asserting that consumers "have been effectively excluded from the development of the UCC").

22. Professor Rogers reports that this was done during the revision process that led to Revised Article 8. See Rogers, *supra* note 7, at 1545 n.166.

23. See *infra* Part III.

24. See *infra* Part IX.

25. See *infra* Part VIII.

26. The issues involving the checking system, for example, although hardly simple ones, have generated a significant body of commentary, much of it from a consumerist viewpoint. See generally Rubin, *Thinking Like a Lawyer*, *supra* note 13 (citing numerous articles on the checking system). "[C]onsumer dissatisfaction with the bankers' practice of 'holding' deposited checks for fairly lengthy periods before allowing customers to withdraw their funds" has led to significant federalization of the rules governing the checking system. Edward L. Rubin, *Uniformity, Regulation, and the Federalization of State Law: Some Lessons from the Payment System*, 49 OHIO ST. L.J. 1251, 1252 (1989).

27. See Hillebrand, *The Uniform Code Drafting Process*, *supra* note 12, at 82-83 (outlining the various barriers hindering the participation of consumer protection groups in the revision process).

28. See Thomas C. Baxter, Jr., *The U.C.C. Thrives in the Law of Commercial Payment*, 28 LOY. L.A. L. REV. 113, 129 (1994) ("To the extent that consumer groups can be more effectively incorporated into the process, and this probably requires some mechanism for funding their participation, then some of the problems of the past can be avoided."). As Professor Rubin notes:



pate from the very beginning, rather than being invited to comment at a later point in the drafting process. This proposal is hardly revolutionary. Beyond the time and resources that major law firms devoted to the Revised Article 8 revision process, the SEC and the Federal Reserve devoted considerable resources to studying problems in the settlement and clearance of securities.<sup>29</sup> At no time, however, did anyone publicly suggest that individuals other than representatives of the regulated industries, their attorneys or their regulators, might appropriately be involved in framing the issues. And, as every good attorney knows, framing the issues is more than half the battle.<sup>30</sup>

## II. RECONCEPTUALIZING SECURITIES OWNERSHIP

### A. *Revised Article 8 and the Indirect Holding System*

Although this Article is not meant as a guide to Revised Article 8 and all of its various provisions,<sup>31</sup> mention should be made of the separate legal regimes created by Revised Article 8 for directly and indirectly held securities. This is the single largest change wrought by Revised Article 8, and one with which the Author has no general quarrel. Currently, most owners of publicly traded securities do not physically hold these securities. The beneficial interests of those owners who are not participants in the securities depository are represented by a book entry at a participant broker-dealer or bank. In turn, these broker-dealers and banks do not usually physically hold these securities. The actual certificates are immobilized at a single depository institution: the Depository Trust Company (DTC) for publicly traded corporate equity and debt securities, municipal debt securities and commercial paper; Participants Trust Company for mortgage-backed securities; and the Federal Reserve System for U.S.

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In order to secure adequate representation of consumer interests on the committee [studying revisions to Articles 3 and 4], the ABA would have needed to pay the expenses of several consumer representatives, committing the funds in a sufficiently definitive manner so that the organizations would be willing to assign significant staff time to the project. The ALI and NCCUSL would have needed to do the same thing for their drafting committee.

Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 762.

29. *See infra* Part X.

30. *See* FRANCIS BERGAN, OPINIONS AND BRIEFS—LESSONS FROM LOUGHRAN 6 (1970) (“The way an issue gets to be stated can have fateful consequences. . . . In law, as in diplomacy, the merits of a point in issue are affected by the way they emerge in language.”).

31. Professor James S. Rogers has prepared a section-by-section analysis for the Hawland, Uniform Commercial Code Series. *See* WILLIAM D. HAWKLAND & JAMES S. ROGERS, REVISED ARTICLE 8: INVESTMENT SECURITIES, 7A UNIFORM COMMERCIAL CODE SERIES (1996). The Anderson treatise also has been revised to address Revised Article 8. *See* 8 RONALD A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE (3d ed. 1996). For an academic discussion of many of these provisions, see Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291.

Treasury Securities. The interests of each depository participant in a particular security immobilized in that depository are memorialized in book entries by the depository. There can be many levels to this indirect holding system between the pertinent depository and the beneficial owner, with an entity at each level creating a book entry memorializing securities' ownership by an entity on the next level down.<sup>32</sup>

This is characterized as an "indirect" holding system because the beneficial ownership of most securities is not reflected in the books of the pertinent issuer. Rather, the issuer's books usually reflect only the name of a nominee. In the case of most shares of publicly traded companies, this is Cede & Co., the nominee DTC uses.<sup>33</sup> The historical rules for transfers of securities reflected in 1977 Article 8 are based on the physical delivery of actual certificates. In contrast, the indirect holding system relies on each entity on each level of this system netting out sales and purchases of each immediately lower level entity for which the higher level entity is acting and making only those net transfers of securities or funds necessary to balance that lower level entity's account. This netting occurs not only on a depository's books for participants in the depository, but also on a broker-dealer or bank's books for its customers. The "basic problem" addressed by Revised Article 8 is the discrepancy between the legal rules for physical delivery of actual certificates incorporated in 1977 Article 8 and the realities of netting and book entries that occur in the indirect holding system.<sup>34</sup>

### B. Securities Entitlements

To deal with this discrepancy, Part 5 has been added to Revised Article 8. Part 5 is based upon the newly created concept of a "securities entitlement." A securities entitlement is not an interest in any particular security; rather, it is the "rights and property interest of an entitlement holder with respect to a financial asset *specified* in Part 5."<sup>35</sup>

Part 5 of Revised Article 8 deals with "financial asset[s]," a category including, but not limited to, securities.<sup>36</sup> Parts 2, 3 and 4 are limited to the narrower category of securities.<sup>37</sup> The definition of "security" in Revised Article 8 combines and tracks the definitions of

32. For a general description of the indirect holding system, see 1994 OFFICIAL TEXT, *supra* note 2, at 2-4.

33. See MARCIA STIGUM, *AFTER THE TRADE: DEALER AND CLEARING BANK OPERATIONS IN MONEY MARKET AND GOVERNMENT SECURITIES* 249 (1988).

34. See 1994 OFFICIAL TEXT, *supra* note 2, at 5.

35. *Id.* § 8-102(a)(17) (emphasis added).

36. See *id.* § 8-102 cmt. 9.

37. See *id.* at 8.

“certificated security” and “uncertificated security” in 1977 Article 8.<sup>38</sup> Financial assets embrace “a broader category of obligations, shares, participations, and interests.”<sup>39</sup> Money market instruments, for example, may be “financial assets” but not “securit[ies].”<sup>40</sup>

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,”<sup>41</sup> i.e., any person whose interest in a financial asset is not registered on the books of the pertinent issuer. Most fundamentally, Revised Article 8 expressly abandons all tracing rules.<sup>42</sup> An entitlement holder has a “pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.”<sup>43</sup> Revised Article 8 requires that four separate conditions be met before an entitlement holder may attempt to assert his or her property rights against the purchaser of a financial asset.<sup>44</sup> One of these four conditions is analogous to 1977 Article 8’s bona fide purchaser rule and will be

38. Compare 1994 OFFICIAL TEXT, *supra* note 2, § 8-102(a)(15), with 1977 OFFICIAL TEXT, *supra* note 4, §§ 8-102(a), (b).

39. 1994 OFFICIAL TEXT, *supra* note 2, § 8-102 cmt. 9.

40. *Id.* at 22. The Prefatory Note discusses “relatively common products and arrangements” and their treatment under Revised Articles 8 and 9, *id.* at 15-27, while revised section 8-103 deals with whether certain “specific investment products” (including equity shares, investment company securities interests in partnerships or limited liability companies, options issued by a clearing corporation and commodity contracts) are “financial assets” or “securities” or neither, *id.*

41. *Id.* § 8-102(a)(7).

42. 1977 Article 8 implicitly rejected tracing by its concepts of a fungible bulk and a customer’s “proportionate property interest in the fungible bulk.” 1977 OFFICIAL TEXT, *supra* note 4, §§ 8-313(2), 8-313 cmt. 4. See also Schroeder, *supra* note 31, at 332-34 (describing netting of trades as leading to impossibility of tracing, both as related to section 8-313(2)). There is nothing implicit in Revised Article 8’s rejection of tracing. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-502 cmt. 2.

43. 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(b).

44. Revised section 8-503(d) provides, in part:

An entitlement holder’s property interest with respect to a particular financial asset under subsection (a) may be enforced against a purchaser of the financial asset or interest therein only if:

- (1) insolvency proceedings have been initiated by or against the securities intermediary;
- (2) the securities intermediary does not have sufficient interests in the financial asset to satisfy the security entitlements of all of its entitlement holders to that financial asset;
- (3) the securities intermediary violated its obligations under Section 8-504 by transferring the financial asset or interest therein to the purchaser; and
- (4) the purchaser is not protected under subsection (e).

1994 OFFICIAL TEXT, *supra* note 2, § 8-503(d). Subsection (a) provides that a financial asset is held by a securities intermediary for the benefit of entitlement holders to the extent necessary to meet the pertinent security entitlements. See *id.* § 8-503(a). Subsection (e) protects transferees and is discussed *infra* Part VI.A.1.

discussed below.<sup>45</sup> These conditions are intended to restrict entitlement holders in most situations to a cause of action against the securities intermediary.<sup>46</sup> The policy behind creating such a high barrier to an entitlement holder's assertion against a purchaser of property rights in any financial asset is that normally an entitlement holder should look only to his or her securities intermediary for performance of the obligations that give content to a securities entitlement.<sup>47</sup> After all, in contrast to the common law concepts underlying 1977 Article 8 that are based on claims to specific physical certificates, Revised Article 8 creates a new type of property interest that "is not a claim to a specific identifiable thing; [rather] it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary."<sup>48</sup>

### III. SYSTEMIC RISK

Revised Article 8 includes little explanation to justify its adoption. The Prefatory Note to Revised Article 8 briefly mentions the "legal uncertainties" created by the prior version of Article 8 and the adverse effects of these uncertainties on "all participants" in securities trading.<sup>49</sup> Professor Rogers has provided a much fuller rationale. He has identified concerns with systemic risk in the financial markets as the impetus for Revised Article 8.<sup>50</sup> Systemic risk is "[t]he risk that inability of one [financial] institution to meet its obligations [to pay funds or transfer securities] when due will cause other [financial] institutions to be unable to meet their obligations [to pay funds or transfer securities] when due."<sup>51</sup> It can arise from any cause that would lead a financial institution to fail, possibly triggering a domino effect. Trading in over-the-counter derivatives, for example, is one area of current concern.<sup>52</sup> The particular systemic risks to which Revised Article 8 is addressed are those arising from clearance and settlement of securities trades.

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45. See *infra* Part V.B.

46. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(d) cmts. 2, 3.

47. See *id.* § 8-503(d) cmt. 2.

48. *Id.*

49. *Id.* at 1.

50. For a recent overview of systemic risk in financial services in general, see RICHARD J. HERRING & ROBERT E. LITAN, FINANCIAL REGULATION IN THE GLOBAL ECONOMY (1995), and, in banking in particular, see *The Domino Effect: A Survey of International Banking*, ECONOMIST, Apr. 27, 1996, at 1 [hereinafter *The Domino Effect*].

51. BANK FOR INTERNATIONAL SETTLEMENTS, CROSS-BORDER SECURITIES SETTLEMENTS 40 (1995) [hereinafter BIS 1995].

52. See *The Domino Effect*, *supra* note 50, at 9-10 (discussing systemic risk concerns in commercial banking arising from OTC derivatives).

### A. *The Bogeyman*

Professor Rogers has justified Revised Article 8 as “one part of worldwide efforts to assure that the clearance and settlement system for securities trading” functions in a way that avoids the creation of systemic risk.<sup>53</sup> One should remember that systemic risk is not a theory that explains the onset of financial crises or provides a full explanation of the development of financial crises.<sup>54</sup> Rather, it should be thought of as the danger that a financial crisis will lead to “a contagious spread of losses across financial institutions that threatens to harm the real economy (the production of goods and services).”<sup>55</sup> Another way of defining systemic risk is to say that it is the risk that a financial market will fail due to its structural reaction to a macroeconomic crisis, which failure, in turn, will be transmitted to other financial markets.<sup>56</sup>

Professor Rogers starts his defense of Revised Article 8 with an eleven-page discussion of systemic risk.<sup>57</sup> Nowhere in these eleven pages or in the balance of his article does Professor Rogers explain the particular aspects of systemic risk that would be alleviated by Revised Article 8. Furthermore, Professor Rogers fails to provide any convincing examples of systemic risk that have arisen from the prior versions of Article 8.<sup>58</sup> In fact, Professor Rogers himself reports that “[s]omewhat to my surprise, I found that, although there were many general expressions to the effect that prior law did not provide a sufficiently certain legal framework for transactions implemented through the modern securities holding system, there was relatively very little specific description of problems.”<sup>59</sup>

Systemic risk is a very serious concern, one that causes reputable commentators to use phrases like “doomsday scenario” and “the stuff of which nightmares . . . are made.”<sup>60</sup> In its simplest form, systemic risk in securities clearance and settlement arises from the possibility

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53. Rogers, *supra* note 7, at 1435.

54. For a description of current theories, see E.P. DAVIS, *INSTABILITY IN THE EUROMARKETS AND THE ECONOMIC THEORY OF FINANCIAL CRISIS* (Bank of England Discussion Paper No. 43, Oct. 1989) at 4-16.

55. HERRING & LITAN, *supra* note 50, at 50.

56. See ORGANIZATION FOR ECONOMIC CO-OPERATION & DEVELOPMENT, *SYSTEMIC RISKS IN SECURITIES MARKETS* 8, 18 (1991) [hereinafter OECD].

57. See Rogers, *supra* note 7, at 1431-42.

58. The *only* example that Professor Rogers provides is the mid-1980s collapse of several government securities dealers and the effects that this had on the mortgage-backed securities market. See *id.* at 1545 n.98. Although there was an initial disruption of the market for mortgage-backed securities because dealers “did not know which of the mortgage-backed securities they were trading was the object an adverse claim,” this disruption was substantially alleviated by publication of a daily list of securities subject to adverse claims. Thomas C. Baxter, Jr. & Ernest T. Patrikis, *Article 8's Adverse Claim Procedures: The Uncharted Hazards of a Safe Harbor*, 20 UCC L.J. 327, 348 (1988).

59. Rogers, *supra* note 7, at 1447.

60. *The Domino Effect*, *supra* note 50, at 12-13.

that one financial institution will fail to meet its obligation to deliver securities or to make a payment to a counterparty. Because of the financial institution's failure, the counterparty in turn may default on its obligations to a third party. Like dominoes, these defaults may "ultimately jeopardi[ze] the stability of payment systems and of financial markets," i.e., produce systemic risk.<sup>61</sup> Faced with such an awesome prospect, who would not agree to whatever measures were reasonably required to lessen the likelihood of a worldwide financial panic and crisis?

The problem with this systemic risk argument, as applied to Revised Article 8, is the one that Professor Rogers' article exemplifies. No one has identified exactly how Revised Article 8 alleviates systemic risk. Some proponents of Revised Article 8 are more blunt than Professor Rogers: "The conclusion that current law creates serious risk of systemic market failure is the SEC's, not mine. I have no basis independent of the SEC studies upon which to form a judgment about the empirical claim that drastic reform of Prior Article 8 is needed."<sup>62</sup>

### B. *The Reality*

This section briefly explores those factual circumstances believed to create systemic risk in the clearance and settlement of securities according to various studies, including those studies upon which Professor Rogers relies. Before describing this particular type of systemic risk, it should be noted that not all writers on financial matters agree that our current financial system, if not reformed, engenders significant systemic risks<sup>63</sup> or, more narrowly, that the failure of a major securities firm would create systemic risk.<sup>64</sup> This Article, however, taking the many systemic risk studies cited by Professor Rogers at their word, assumes that significant risks are contained within the clearance and settlement systems for securities. Once the concerns of the studies are examined, it becomes clear that, in most respects, Revised Article 8 is unrelated to these concerns.

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61. BANK FOR INTERNATIONAL SETTLEMENTS, DELIVERY VERSUS PAYMENT IN SECURITIES SETTLEMENT SYSTEMS 1 (1992) [hereinafter BIS 1992].

62. Memorandum from Paul M. Shupack, Chair of Working Group, Article 8 Bar Report, to Members of the Uniform State Laws Committee of the Association of the Bar of the City of New York 1 (June 6, 1995) (on file with author) [hereinafter Shupack Memorandum]. Professor Shupack never discusses the SEC reports on which he is relying or what empirical support these reports provide. This Author does not believe that there is a substantial empirical basis for Revised Article 8.

63. See, e.g., Ben S. Bernanke, *Clearing and Settlement During the Crash*, 3 REV. FIN. STUD. 133 (1990); Ethan B. Kapstein, *Shockproof: The End of the Financial Crisis*, 75 FOREIGN AFF. 2 (1996).

64. See, e.g., HERRING & LITAN, *supra* note 50, at 72-73.

The studies of systemic risk in the banking industry created the conceptual framework that has been carried over to studies of the securities industry.<sup>65</sup> In 1989, a group of banking experts on payment systems issued a report on financial netting arrangements.<sup>66</sup> This report discussed the risks present in a payment netting system. Two basic risks exist: credit risk and liquidity risk.<sup>67</sup> Credit risk “is the risk that a counterparty will not meet an obligation when due, and will never be able to meet that obligation for full value.”<sup>68</sup> Liquidity risk “is the risk that clearing, or settlement, payments will not be made when due, even though one or more counterparties do have sufficient assets and net worth ultimately to make them.”<sup>69</sup>

These two concepts have been applied in a multitude of studies to clearance and settlement in the securities, options and futures markets to flesh out possible systemic risks and possible solutions. Clearance is the process by which counterparties in the securities, options and futures markets compare buy-and-sell orders to confirm that both sides to a transaction agree to its terms. Settlement is the process by which both counterparties fulfill their obligations, which in a traditional stock trade means “payment to the seller and delivery of the stock . . . certificate[ ] or transferring its ownership to the

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65. See BIS 1992, *supra* note 61, at 2-3 (“In general, the types and sources of financial risk in the clearance and settlement of contracts for the purchase and sale of securities are the same as those that arise in the clearance and settlement of foreign exchange contracts, which were analyzed in considerable detail in the Angell Report [*infra* note 66] and the Lamfalussy Report [*infra* note 75].”).

66. See GROUP OF EXPERTS ON PAYMENT SYSTEMS OF THE CENTRAL BANKS OF THE GROUP OF TEN COUNTRIES, REPORT ON NETTING SCHEMES (1989) [hereinafter ANGELL REPORT]. This report is often called the “Angell Report” after Warren D. Angell, who was a member of the Board of Directors of the Federal Reserve Board and Chairman of the group of experts.

67. See *id.* at 9-10.

68. *Id.* at 9. Credit risk is often, but not always, a result of the bankruptcy of a counterparty. The nature of a netting system will determine how the loss is measured:

In a *payment* netting system, losses from defaults due to the bankruptcy of counterparties can be measured as the principal amount due less recoveries from defaulting parties. Forgone interest can also be an important loss. In an *obligations* netting system, losses from the default of a counterparty would typically be calculated from the replacement costs of one or more contracts that are not settled. If, however, one party to a contract defaults after having received settlement payments from another party, but before making required counter-payments (in the same or another currency), the loss would again be for a principal amount (less recoveries).

*Id.* at 9-10 (citation omitted).

69. *Id.* at 10. “Operational risk,” a third type of risk that this Article does not discuss, is the “risk of a breakdown of some component of the hardware, software, or communications systems that are critical to settlement of financial transactions.” PATRICK PARKINSON ET AL., CLEARANCE AND SETTLEMENT IN U.S. SECURITIES MARKETS 7 (Board of Governors of the Federal Reserve System Staff Study No. 163, Mar. 1992) [hereinafter FEDERAL RESERVE STUDY 1992].

buyer.”<sup>70</sup> Although different markets have different clearance and settlement procedures, this Article will not explore the nuances created by these differences for systemic risk analysis.

The financial market studies have looked at the risks that arise both before and during the settlement process. Prior to settlement, credit risk can be measured by “the cost of replacing the original contract at current market prices” (“replacement cost risk”).<sup>71</sup> Replacement cost risk is a factor of “the volatility of the securities price and the amount of time that elapses between the trade date and the settlement date.”<sup>72</sup> One recent step to lessen replacement cost risk has been the SEC’s shortening of settlement for most publicly traded corporate equity and debt securities from the fifth business day after the trade date to the third business day after the trade date (“T + 3”).<sup>73</sup> This, of course, is not a regulatory initiative that implicates Revised Article 8. Creation of “legally binding trade netting systems” is the other recommended general means of reducing replacement cost risk.<sup>74</sup> This is primarily a matter of contract law involving such issues as whether netting arrangements are purely bookkeeping arrangements in which the underlying obligations remain outstanding, or rather true novations in which only a single new, net obligation remains outstanding.<sup>75</sup> Revised Article 8 is relevant to netting

70. OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, ELECTRONIC BULLS AND BEARS 107 (1990). For overviews and further descriptions of clearing and settlement in the United States, see *id.* at 181-93; STIGUM, *supra* note 33, at 278. In addition, there are a number of useful papers and memoranda in the contractor report prepared by the Bankers Trust Company for the Office of Technology Assessment. See 1-5 BANKERS TRUST COMPANY, STUDY OF INTERNATIONAL CLEARING AND SETTLEMENT (Oct. 1989). Volume 1 of the Bankers Trust Company study provides an executive summary of the United States material at pages 34-69.

71. BIS 1992, *supra* note 61, at 3. Of course, if the price of the pertinent contract has declined, there would be no additional cost. Some studies use the term “market risk” to describe what this article calls “replacement cost risk.” See, e.g., OECD, *supra* note 56, at 31.

72. BIS 1992, *supra* note 61, at 3.

73. See Securities Transaction Settlement, Release No. 33-7022 (Oct. 12, 1993), 58 Fed. Reg. 52,891 (1993). Commercial paper, commercial bills, bankers’ acceptances, limited partnership interests that are not publicly traded, and certain securities sold pursuant to “a firm commitment underwritten offering registered under the Securities Act of 1933” are excluded. 17 C.F.R. § 240.15c6-1(c) (1998). The SEC currently is considering mandating same-day settlement. See Arthur Levitt, Remarks at “Speeding Up Settlement: The Next Frontier,” SEC Symposium on Risk Reduction in Payments, Clearance and Settlement Systems 6 (Jan. 26, 1996), available in 1996 WL 29441 (S.E.C.) at \*3. The largest securities market in the United States, both in dollar amount and in average daily volume, is the United States government securities market. See FEDERAL RESERVE STUDY 1992, *supra* note 69, at 5 chart 2. Most trades in this market are settled on the day of trade or the next day. See *id.* at 22-23.

74. BIS 1992, *supra* note 61, at 3.

75. See BANK FOR INTERNATIONAL SETTLEMENTS, REPORT OF THE COMMITTEE ON INTERBANK NETTING SCHEMES OF THE CENTRAL BANKS OF THE GROUP OF TEN COUNTRIES 16 (1990) [hereinafter BIS 1990] (“[O]nly if the net amounts are legally binding in the event of a counterparty’s closure will the participants experience reductions in their true credit and liquidity exposures.”). This report is often called the “Lamfalussy Report” after



schemes insofar as clearing organizations become counterparties in netting arrangements.<sup>76</sup> Clearing organizations and Revised Article 8 are discussed in Part VI.C. of this Article.

The primary focus of Revised Article 8, and the area about which the most concern with regard to securities markets has been expressed,<sup>77</sup> is the settlement of securities transactions. The scenario prompting the concerns with systemic risk starts with “a sharp and sudden fall in prices of securities or derivatives” in a single market.<sup>78</sup> This fall then is transmitted to other financial markets.<sup>79</sup> The recent example of market contagion cited by most studies is the October 1987 market crash in the United States that spread to the related futures and options markets and overseas equity markets.<sup>80</sup> The final step is “the failure of one or more major intermediaries,” which finally “generates a crisis in the core banking and payments system.”<sup>81</sup> Settlement procedures play a role in systemic risk analysis primarily as transmitters of financial failure and secondarily as independent sources of systemic risk.<sup>82</sup> The possible transmission risk can arise directly from the failure of a counterparty, usually from bankruptcy, or indirectly from the failure of a clearing organization that became the counterparty to its members’ transactions.<sup>83</sup> The possible independent risks can arise from operational failures such as computer breakdowns<sup>84</sup> or from problems arising from the interaction of different settlement systems.<sup>85</sup> The latter independent risk can arise, for example, from different settlement times in different systems. If buyer A is purchasing securities X in market B and simultaneously selling the same securities X in market A and if market B settles at 3 p.m. and market A at 2 p.m., it will be difficult for buyer A to execute both the purchase and the sale in the same day. These difficulties can be overcome by any number of techniques. For example, cash and securities can be pre-positioned in the relevant markets or borrowed.

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M. A. Lamfalussy, the chairman of the committee. For a description of the possible legal forms of netting and the risks created by various institutional netting arrangement, see ANGELL REPORT, *supra* note 66, at 11-26.

76. See BIS 1990, *supra* note 75, at 17-19; ANGELL REPORT, *supra* note 66, at 18-21.

77. See BIS 1992, *supra* note 61, at 3 (“By far the largest financial risks in securities clearance and settlement occur during the settlement process . . .”).

78. OECD, *supra* note 56, at 17.

79. See *id.*

80. See, e.g., *id.* at 13, 17. Luckily, not all financial markets were affected, see *id.* at 13, which is another way of saying that a systemic crisis was not triggered.

81. *Id.* at 17.

82. See *id.* at 35.

83. See *id.* at 36.

84. See FEDERAL RESERVE STUDY 1992, *supra* note 69, at 16-17.

85. See BIS 1995, *supra* note 51, at 3. Although this report is concerned with cross-border settlements, most of its discussion of basic risks would apply to a domestic market where settlements with respect to a particular security were not made through a single central clearing organization.

But any such technique raises liquidity issues that, if large enough, may themselves create potential systemic risk.<sup>86</sup>

### C. Reducing Systemic Risks

A variety of recommendations have been made for reducing systemic risk in the clearing and settlement of securities. The template against which all these recommendations are measured is a 1989 report by the Group of Thirty.<sup>87</sup> The Group of Thirty made nine recommendations, of which the most relevant to Revised Article 8 is that “[d]elivery versus payment (DVP) should be employed as the method for settling all securities transactions. A DVP system should be in place by 1992.”<sup>88</sup> On its face, this recommendation does not seem di-

86. One study labels this as a type of “pipeline liquidity cost” that creates “pipeline liquidity risk.” MORGAN GUARANTY TRUST CO. OF N.Y. AS OPERATOR OF THE EUROCLEAR SYSTEM, CROSS-BORDER CLEARANCE, SETTLEMENT, AND CUSTODY: BEYOND THE G30 RECOMMENDATIONS 9, 11 (1993). In most domestic clearing arrangements, “the banking sector typically absorbs these costs by providing uncompensated intra-day credit to bridge the gaps in time during which assets are in fact blocked in a settlement pipeline.” *Id.* at 9. If no intra-day credit is available, the market participants bear the pipeline liquidity risk through pre-funding their accounts. *See id.* at 14.

87. *See* GROUP OF THIRTY, CLEARANCE AND SETTLEMENT SYSTEMS IN THE WORLD’S SECURITIES MARKETS (1989).

88. *Id.* at 11 (Recommendation 5). The other eight recommendations are:

Recommendation 1:

By 1990, all comparisons of trades between direct market participants (i.e., brokers, broker/dealers and other exchange members) should be accomplished by T+1.

Recommendation 2:

Indirect market participants (such as institutional investors, or any trading counterparties which are not broker/dealers) should, by 1992, be members of a trade comparison system which achieves positive affirmation of trade details.

Recommendation 3:

Each country should have an effective and fully developed central securities depository, organi[z]ed and managed to encourage the broadest possible industry participation (directly and indirectly), in place by 1992.

Recommendation 4:

Each country should study its market volumes and participation to determine whether a trade netting system would be beneficial in terms of reducing risk and promoting efficiency. If a netting system would be appropriate, it should be implemented by 1992.

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Recommendation 6:

Payments associated with the settlement of securities transactions and the servicing of securities portfolios should be made consistent across all instruments and markets by adopting the “same day” funds convention.

Recommendation 7:

A “Rolling Settlement” system should be adopted by all markets. Final settlement should occur on T+3 by 1992. As an interim target, final settlement should occur on T+5 by 1990 at the latest, save only where it hinders the achievement of T+3 by 1992.

Recommendation 8:

Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Existing regulatory and taxa-

rectly relevant to Revised Article 8; however, supporters of Revised Article 8 have focused on finality, the policy behind this recommendation, for support.<sup>89</sup> The supporters of Revised Article 8 maintain that finality in securities transactions should mean that a third party could challenge a securities transfer only in the most unusual circumstances. Professor Rogers labels this as “post-settlement finality.”<sup>90</sup> By post-settlement finality, Professor Rogers means the situation where, subsequent to the settlement between Firm A and Firm B,

[A] third party (“Claimant”) appears and asserts that the securities that Firm A transferred to Firm B really belonged to or otherwise were subject to a property interest in favor of Claimant and should not have been transferred by Firm A to Firm B. To the extent that the applicable legal rules permit the Claimant to recover the securities from Firm B on such grounds, Firm B faces a form of settlement risk that continues even beyond the point at which it appeared that the transaction had settled.<sup>91</sup>

Post-settlement finality concern has such a tenuous connection to the numerous studies of settlement and clearance that Professor Rogers is only able to find one study that even discusses it.<sup>92</sup> This is not surprising as the experience under 1977 Article 8 lends no empirical support to the concern that Professor Rogers raises.<sup>93</sup>

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tion barriers that inhibit the practice of lending securities should be removed by 1990.

Recommendation 9:

Each country should adopt the standard for securities messages developed by the International Organization for Standardization [ISO Standard 7775]. In particular, countries should adopt the ISIN numbering system for securities issues as defined in the ISO Standard 6166, at least for cross border transactions. These standards should be universally applied by 1992.

*Id.* at 3, 5, 7, 9, 11, 13, 14, 16, 18.

89. Recommendation 8 is also relevant in evaluating Revised Article 8. This recommendation is meant to address the problem of a failure to deliver securities by a counterparty. If the party that has not received securities has delivery obligations to another counterparty with respect to these securities, the party can meet these delivery obligations by borrowing replacement securities. *See id.* at 47-48. As with Recommendation 5, finality is one of the policies underlying Recommendation 8. In other words, no party will borrow securities and no counterparty will accept borrowed securities unless each can be sure that it has received a transfer that cannot be unwound.

90. Rogers, *supra* note 7, at 1461.

91. *Id.*

92. *See id.* at 1461 n.42 (citing BIS 1995, *supra* note 51, at 53-54). This 1995 study notes that “some legal systems have developed the concept of ‘negotiability’ to deal with this problem. BIS 1995, *supra* note 51, at 54. Nowhere does the Bank for International Settlements indicate that negotiability does not do its job and that it needs the radical reform provided by Revised Article 8.

93. The one empirical example that Professor Rogers cites to support his concerns is discussed *supra* note 58.

### 1. Orange County Bankruptcy

Professor Rogers uses a hypothetical involving securities held as collateral for Orange County's debt to illustrate potential post-settlement finality issues. If the sale of the collateral securities was not structured properly, the purchasers would not enjoy bona fide purchaser protection under 1977 Article 8.<sup>94</sup> An examination of the actual events in the Orange County bankruptcy<sup>95</sup> establishes that there were no adverse claims problems that would have been addressed or alleviated by Revised Article 8. Although this Author has no quarrel with Professor Rogers' description of what is possible, this Author is skeptical that, as a practical matter, securities held as collateral for a bankrupt debtor as notorious as Orange County<sup>96</sup> and that were of a material amount in value could be transferred without knowledgeable commercial lawyers being involved on both the sale and purchase sides.<sup>97</sup> Even if the lawyers had only represented the selling collateral holders and not the ultimate purchasers, the lawyers presumably would have advised their clients that, under 1977 Article 8, the collateral holder would have made a warranty that the transfer was "effective and rightful"<sup>98</sup> and, therefore, should not transfer securities as to which there were probable adverse claims.

94. See Rogers, *supra* note 7, at 1466-67. Professor Rogers contrasts a hypothetical settlement through entries "on the books of a clearing corporation," which can lead to bona fide purchaser status under 1977 Article 8, to settlement through an entry on the books of a securities intermediary, which cannot lead to bona fide purchaser status, relying presumably on sections 8-313(1)(g) and (2) of the 1977 OFFICIAL TEXT, *id.* at 1466.

95. Professor Rogers has avoided any such examination. See Rogers, *supra* note 7, at 1466 n.51 ("No inference is intended concerning any issues that may actually have arisen out of the Orange County matter itself—a matter on which the Author is wholly ignorant.").

96. Orange County's potential financial difficulties were known to Wall Street as early as August 1994. See Laura Jereski et al., *Bitter Fruit: Orange County, Mired in Investment Mess, Files for Bankruptcy*, WALL ST. J., Dec. 7, 1994, at A1 (reporting that Orange County filed a Chapter 9 bankruptcy petition, and the county had over \$7 billion in outstanding public debt). And, when the collateral sales were made, they were large enough relative to the market to lead to "fire-sale prices." Laura Jereski, *Orange County Fund Losses Put at \$2.5 Billion: Bond Price Drop, Street's Rush to Sell Are Cited as Portfolio Weakens*, WALL ST. J., Dec. 12, 1994, at A3 (reporting that the Orange County fund consisted of investments by more than 180 California local governments and agencies, worth over \$7.5 billion); Michael Siconolfi & Anita Raghavan, *Orange County Crisis: The Fallout*, WALL ST. J., Dec. 8, 1994, at A13 (discussing whether the fund could sell securities held as loan collateral).

97. The collateral holders in the Orange County Bankruptcy consulted their attorneys before disposing of their collateral. See Stephen J. Sansweet & Rhonda L. Rundle, *Orange County Hires Financial Experts, Says It Will Sue Some Wall Street Firms*, WALL ST. J., Dec. 9, 1994, at A3. One might expect purchasers of any sophistication to also seek legal counsel as the combination of publicly available information about Orange County plus the discount prices would have alerted such purchasers to the possibility they might be purchasing Orange County collateral.

98. 1977 OFFICIAL TEXT, *supra* note 4, §§ 8-306(2)(a) (certificated securities), 8-306(9)(a) (uncertificated securities).

Orange County officials filed for bankruptcy under Chapter 9 of the United States Bankruptcy Code on December 6, 1994, after Orange County's investment portfolio plummeted in value.<sup>99</sup> The county had purchased inverse floaters<sup>100</sup>—high-risk derivatives—from various Wall Street firms using the cash proceeds from repurchase agreements. The county, as the seller in the repurchase agreements, agreed to repurchase the securities that were sold pursuant to the repurchase agreements and gave the purchasing Wall Street firms collateral for these repurchase obligations.<sup>101</sup> As interest rates rose during 1994, the value of both the collateral securities and the inverse floaters declined.<sup>102</sup>

When Orange County defaulted under one repurchase agreement, CS First Boston sold \$2.6 billion in securities held as collateral.<sup>103</sup> This precipitated the bankruptcy filing, which was intended to prevent other firms from selling their collateral.<sup>104</sup> Despite Orange County's intention, other firms that held securities as collateral were quick to sell these securities; by Friday, December 9, 1994 they had collectively sold nearly \$11.4 billion out of a total of \$15 billion in collateral.<sup>105</sup>

Instead of seeking to enjoin the sale of securities held as collateral, Orange County chose to sue for damages, arguing that the "automatic stay" provision under Chapter 9 prohibited such sales.<sup>106</sup> The Wall Street firms contended that the automatic stay provision did not apply to repurchase agreements.<sup>107</sup> By early 1995, Orange County decided to bring only one test case against Merrill Lynch & Co. and voluntarily dropped a suit against one of the other firms.<sup>108</sup> Although some secured lenders hesitated in liquidating their collat-

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99. See Jereski et al., *supra* note 96, at A3.

100. The yield on inverse floaters increases as market interest rates decline and decreases as market interest rates rise. Robert C. Downs & Lenora J. Fowler, *Derivative Securities: Governmental Entities as End Users, Bankrupts and Other Big Losers*, 65 UMKC L. REV. 483, 493 (1997). Orange County used the inverse floaters to hedge a portfolio of securities issued by the Federal National Mortgage Association and the Federal Home Loan Bank System against declines in interest rates. William K. Maready, Jr., *Regulating for Disaster: Federal Attempts to Control the Derivatives Market*, 31 WAKE FOREST L. REV. 885, 887-88 (1996).

101. See Siconolfi & Raghavan, *supra* note 96, at A13. Presumably this collateral consisted of the securities that were the subject of the repurchase agreement. See Public Securities Association, Master Repurchase Agreement § 6, *reprinted in* MARCIA STIGUM, THE REPO AND REVERSE MARKETS 236, 238 (1989) [hereinafter STIGUM, REPO].

102. See Jereski et al., *supra* note 96, at A1.

103. See Sansweet & Rundle, *supra* note 97, at A3.

104. See Jereski et al., *supra* note 96, at A1.

105. See *id.* at A3.

106. Andy Pasztor, *Orange County Has No Choice But to Sue Over Sold Collateral*, WALL ST. J., Dec. 13, 1994, at B11.

107. See Siconolfi & Raghavan, *supra* note 96, at A13.

108. See Andy Pasztor, *Orange County Suit Against Nomura Is Dropped for Now*, WALL ST. J., Mar. 2, 1995, at B10.

eral,<sup>109</sup> most positions were liquidated quickly and easily. None of the problems predicted by supporters of Revised Article 8 occurred. The securities markets functioned effectively and without evident problems in absorbing the collateral. No concerns over adverse claims or finality materially hindered this process.

## 2. Transaction Costs

Other commentators on international clearance and settlement have been motivated as much, if not more, by a desire to reduce “friction” or “transaction” costs as by a desire to preclude systemic risk.<sup>110</sup> To these commentators, the “legal uncertainties and friction costs in obtaining valid transfers and pledges of interests in securities currently may be preventing a large portion of the world’s stock of securities from being put to one of its highest and best uses when opportunities for such use arise.”<sup>111</sup> These problems may lead to a higher cost of credit and lower the value of securities. These economic efficiency issues, though of concern, do not provide the compelling sense of urgency that Professor Rogers’ systemic risk argument provides. This Article will not examine the economic efficiency issue because very little of the literature on clearance and settlement addresses it and because it is not the primary argument made in favor of Revised Article 8.

A focus on economic efficiency would shift the discussion from systemic risk to one of the relative costs of tradeoffs between protection for individual investors and reduced costs for institutions that carry out clearance and settlement, which presumably are ultimately reflected through competition in reduced costs for investors. In addition, certain measures advocated by supporters of Revised Article 8, such as the super-priority of control lenders to clearing corporations,<sup>112</sup> can lead to their own increased transaction costs;<sup>113</sup> there-

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109. Siconolfi & Raghavan, *supra* note 96, at A13. Smith Barney, Inc. circulated a bid list for the \$800 million of collateral bonds it held and then withdrew the list. Prudential Securities, Inc. sold some of the \$1 billion in securities it held as collateral and then bought these securities back. *See id.* Nothing in the publicly available literature gives any insight into why these steps were taken. Whatever concerns Smith Barney and Prudential had, other repo purchasers and the market in general did not share these same concerns.

110. *See, e.g.*, MORGAN GUARANTY TRUST COMPANY OF NEW YORK AS OPERATOR OF THE EUROCLEAR SYSTEM, *supra* note 86; RANDALL D. GUYNN, MODERNIZING SECURITIES OWNERSHIP, TRANSFER AND PLEDGING LAWS (1996) [hereinafter GUYNN, MODERNIZING].

111. GUYNN, MODERNIZING, *supra* note 110, at 6.

112. *See infra* Part VI.B. for a discussion of this superpriority issue.

113. *See* ANGELL REPORT, *supra* note 66, at 19. As the chance of clearing corporation failure is reduced in Revised Article 8 by using participants’ assets as collateral, one would expect that unsecured creditors would raise the cost of credit to the participants. *See id.*

However, it is not clear that such market mechanisms would work adequately, particularly if the amounts of collateral posted were not disclosed to creditors; and in any case it could be harder for participants to assess the creditworthi-

fore, the goal of reducing transaction costs in the clearing and settlement system as a whole might not be met.

### 3. *October 1987 Market Crash*

Professor Charles W. Mooney, Jr., the legal academic whose ideas form the intellectual underpinnings of Revised Article 8,<sup>114</sup> is no more convincing on the empirical issues. In discussing “the potentially severe consequences of prevailing uncertainties in the legal regime,”<sup>115</sup> he cites to the October 1987 market crash and the 1990 bankruptcy of Drexel Burnham Lambert Group, Inc. (DBL Group).<sup>116</sup>

This Article does not purport to make a detailed survey of the sources concerning the October 1987 Market Crash. Instead, it assumes that the supporters of Revised Article 8 have found the most relevant support for their position. When these sources are examined, the argument that 1977 Article 8 had to be thoroughly revised because of a general reluctance by “bank lenders . . . to extend credit necessary to provide vital liquidity because of uncertainty as to perfection and priority of security interests in collateral”<sup>117</sup> turns out to be a vast overgeneralization.

Professor Mooney cites a 1988 study by the SEC as support for this generalization.<sup>118</sup> When looking at the study, one finds that the SEC was not discussing general problems in perfecting security interests but rather problems identified by the Options Clearing Corporation (“OCC”) with respect to perfecting security interests in options.<sup>119</sup> As options exist exclusively as book entries, methods for perfection differed between 1962 and 1977 Article 8. There were also different choice of law provisions under these two versions of Article 8, which could lead to different results. The study concluded that “[a]lthough it is possible to perfect security interests using both methods, doing so is both cumbersome and error-prone.”<sup>120</sup> While these problems can be generalized to cover all securities that exist

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ness of the clearing house than that of their individual counterparties in the markets.

*Id.* This lack of certainty can be its own independent source of systemic risk.

114. See Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 *CARDOZO L. REV.* 305 (1990).

115. *Id.* at 315.

116. See *id.* at 315 n.13.

117. Mooney, *supra* note 114, at 315 n.13.

118. See *id.* (citing DIVISION OF MARKET REGULATION, SEC, *THE OCTOBER 1987 MARKET BREAK* (1988), reprinted in BERNARD D. REAMS, JR., 2 *THE STOCK MARKET CRASH OF OCTOBER 1987: FEDERAL DOCUMENTS AND MATERIALS ON THE VOLATILITY OF THE STOCK MARKET AND STOCK INDEX FUTURES MARKETS* 10-56 (1988) [hereinafter *OCTOBER 1987 MARKET BREAK*]).

119. See *OCTOBER 1987 MARKET BREAK*, *supra* note 118, at 10-56.

120. *Id.*

solely as book entries, the solution does not necessarily implicate the upper tier priority and finality policies for which Professors Mooney and Rogers,<sup>121</sup> respectively, are the chief spokespersons. Nor do they necessarily lead to the choice to favor control lenders over individual investors.

Later academic studies have not been any kinder to Revised Article 8 supporters. The few studies that have examined clearing and settlement during the October 1987 crash have not even mentioned problems in perfecting security interests as something of concern.<sup>122</sup> Also, there are no contemporaneous or subsequent articles in the business press that report on problems in perfecting security interests.<sup>123</sup>

#### 4. DBL Group's Bankruptcy

The evidence from DBL Group's bankruptcy similarly does not support the notion that problems in perfecting security interests in securities present a serious danger to America's financial markets.<sup>124</sup> Richard C. Breeden, SEC Chairman at the time of the bankruptcy,

121. Professor Rogers' citation to a source studying the October 1987 crash is even more general and vague than Professor Mooney's. See Rogers, *supra* note 7, at 1446 n.23. Professor Rogers cited to the INTERIM REPORT OF THE WORKING GROUP ON FINANCIAL MARKETS, reprinted in REAMS, *supra* note 118, app. D at 15-16. In a single paragraph, the *Interim Report* advocates "uniform transfer, delivery and pledge requirements for options and uncertificated securities" so that there is no uncertainty in what law to apply and so that all states' laws recognize uncertificated securities. *Id.*

122. See, e.g., Bernanke, *supra* note 63.

123. See, e.g., Kurt Eichenwald, *The Day the Nation's Cash Pipeline Almost Ran Dry*, N.Y. TIMES, Oct. 2, 1988, § 3 at 11; James B. Stewart & Daniel Hertzberg, *Terrible Tuesday: How the Stock Market Almost Disintegrated a Day After the Crash*, WALL ST. J., Nov. 20, 1987, at 1. Stewart & Hertzberg do report a number of instances where banks refused to extend credit to securities firms. On October 19, Bankers Trust Co., for example, refused to extend any unsecured credit to broker-dealers. Other banks called in loans to broker-dealers. *Id.* These problems are more likely the result of standard commercial considerations than of concerns over legal rights. Unclear, however, is why any prudent lender would extend credit, secured by assets declining in value, as did securities on Black Monday. The Federal Reserve Board resolved this crisis by pressuring banks to resume lending and by injecting liquidity into the banking system. *Id.* However, these actions did not bear fruit until there were independent signs that a rally was starting in the markets. *Id.*

124. There was no risk of a run on the bank, with most retail customers attempting to close with their accounts from DBL Group's broker-dealer subsidiary, as the retail sales operation had been shut down in spring 1989. See Steve Swartz & David J. Jefferson, *Drexel Will Sell Brokerage Unit, Make Cutbacks*, WALL ST. J., Apr. 19, 1989, at B1. Over 300,000 customer accounts were transferred in 1989; only 30,000 customer accounts had to be transferred after the bankruptcy. See UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-92-70, SECURITIES FIRMS: ASSESSING THE NEED TO REGULATE ADDITIONAL FINANCIAL ACTIVITIES 76, 77 n.4 (1992) [hereinafter GAO, SECURITIES FIRMS]; see also DAN G. STONE, APRIL FOOLS: AN INSIDER'S ACCOUNT OF THE RISE AND COLLAPSE OF DREXEL BURNHAM (1990) (describing the impact of the layoffs occasioned by the shutdown of the retail sales and other departments on Drexel employees). Such a run, of course, could have been a separate source of systemic risk.



gave a detailed report on the bankruptcy to a Senate committee.<sup>125</sup> Mr. Breeden summarized his conclusion about the DBL Group's failure in the following words: "In a sense, this is an old and all too familiar story: Drexel's [the broker-dealer's] parent borrowed billions short in order to lend long. Such a strategy inevitably exposes the firm to failure if total confidence in the firm is not continuously maintained."<sup>126</sup>

The bankruptcy was of the holding company, DBL Group. The broker-dealer (DBL) and government bond dealer (GSI) subsidiaries did not become insolvent.<sup>127</sup> Although DBL Group and DBL had settled felony charges of insider trading with the SEC in March 1989 for \$650 million, \$500 million of which had been paid when the bankruptcy had been filed, DBL "remained among the highest capitalized broker-dealers in the United States."<sup>128</sup> But, during 1989, the decline of the junk bond market had a negative impact on the profitability of both DBL Group and DBL.<sup>129</sup> A growing number of junk bond issuer defaults led to increased illiquidity in the junk bond market<sup>130</sup> and a decrease in the number of new junk bond issues.<sup>131</sup> In addition, DBL's share of new junk bond underwritings fell significantly in 1989.<sup>132</sup> DBL found itself with declining trading and underwriting income.<sup>133</sup> In addition, the junk bond inventory held by DBL Group and its affiliates had become "more difficult to sell."<sup>134</sup>

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125. See *Lessons to Be Learned from the Drexel Failure and Possible Regulatory Changes: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong. 5-60 (1990) [hereinafter *Drexel Hearings*].

126. *Id.* at 12 (statement of SEC Chairman Richard C. Breeden).

127. See *id.* at 45.

128. *Id.* at 29-30.

129. For an overview of these and other factors leading to the Drexel entities' bankruptcy filings, see Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code at 27-34, *In re The Drexel Burnham Lambert Group, Inc.*, Chapter 11 Case No. 90 B 10421 (FGC) (Bankr. S.D.N.Y. Oct. 25, 1991) [hereinafter *Debtors' Disclosure Statement*].

130. By late Fall 1989, DBL and other broker-dealers were no longer making markets in many junk bonds. Without a dealers' market to trade junk bonds, there was no easy way to trade many of them. Leah J. Nathans, *The Junk Market's Black Hole*, *BUS. WK.*, Nov. 27, 1989, at 56.

131. See Roger E. Alcala, *The Golden Age of Junk*, N.Y. REV. BOOKS, May 26, 1994, at 34 chart 2 (in 1989 high yield bonds comprised 20.14% of the total principal amount of new corporate issues and 1.28% in 1990).

132. See Michael Siconolfi, *Drexel Collapse Makes Orphans of \$4 Billion in Junk Offerings*, *WALL ST. J.*, Feb. 16, 1990, at C1. DBL did approximately 50% of the new underwritings of junk bonds in 1988 and approximately 33% in 1989. See *id.*

133. See *Drexel Hearings*, *supra* note 125, at 32-33. Before October 1989, DBL's average daily volume of junk bond trading was \$400 million per day. By December 1989, this had become \$150 million per day. See *id.* at 32. Although not explicitly emphasized by Mr. Breeden, such a decline should have materially impacted DBL's trading revenues.

134. *Id.* at 33. This inventory totaled approximately \$1 billion as of December 29, 1989. See *Id.* at 33-34. Many of the securities and other financial assets held by the Drexel entities were obligations of companies in severe financial difficulty themselves, sometimes even in bankruptcy. DBL Group held "a significant portion of" two debenture offerings in

DBL Group's reliance on an unsecured commercial paper program of over \$1 billion to finance its operations was the immediate cause of its bankruptcy. The program's proceeds were used to fund "illiquid privately placed investments" in DBL Group's unregulated subsidiaries.<sup>135</sup> DBL Group had no backup collateral pool that would support secured bank loans, which became necessary when, in December 1989, DBL Group's credit rating was reduced by Standard & Poor's from A-2 to A-3.<sup>136</sup> On February 12, 1990, DBL Group lost all access to the commercial paper market when Standard & Poor's downgraded DBL Group's commercial paper to "speculative grade."<sup>137</sup> In addition, in early February 1989, both the SEC and the NYSE had advised DBL that DBL could no longer make any loans to DBL Group or its affiliates without prior consultations with the SEC or prior written consent of the NYSE, respectively.<sup>138</sup> The only remaining hope for DBL Group was to secure a collateralized bank loan or a substantial equity investment, neither of which could be arranged.<sup>139</sup> "Given Drexel's ongoing significant contingent liabilities, this result was not surprising."<sup>140</sup>

In Mr. Breeden's account, the reluctance of banks to make a secured loan to DBL Group was due to standard commercial considerations. DBL Group was a holding company whose major subsidiary, DBL, was a leading player in a precipitously declining market. In addition, the assets that DBL Group could pledge to lenders consisted of "only illiquid privately placed investments in the unregulated subsidiaries and the excess uncollateralized securities inventory of DBL, its regulated broker-dealer."<sup>141</sup> Why would any lender

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the aggregate principal amount of \$450,000,000 (Australian) of an Australian company in receivership. Debtors' Disclosure Statement, *supra* note 129, at 28. DBL Group and certain of its subsidiaries had provided "a bridge loan facility and certain other financings" for an acquisition vehicle that was "negotiating an out-of-court restructuring." *Id.* at 29. Also, DBL had been "unable to sell a significant portion of two of the three securities offerings" in an aggregate principal amount of \$385,000,000 for an issuer that went through a "pre-packaged" Chapter 11 case. *Id.* at 30.

135. *Drexel Hearings*, *supra* note 125, at 34 (statement of SEC Chairman, Richard C. Breeden). This mismatch between "short-term funds" and the "long term illiquid assets" financed by such funds "dramatically" increased the risk of failure for DBL Group. *Id.* at 134 (Richard C. Breeden, Response to Written Questions).

136. *See id.* at 34. This downgrading meant that the DBL Group's commercial paper could no longer be purchased by money market funds, shrinking the number of potential lenders to DBL Group. The remaining lenders began to withdraw financing from DBL Group during January 1990. *See id.* at 35.

137. *Id.* at 41.

138. *See id.* at 37.

139. *See id.* at 41-42.

140. *Id.* at 42.

141. *Id.* at 34. In part, DBL had excess securities in its inventories because, since spring 1989, there had been no retail sales force that could help sell these securities and syndicating deals to other Wall Street broker-dealers was not feasible. *See STONE*, *supra* note 124, at 184.

want to make a loan secured by such illiquid assets with questionable value to a borrower whose survival was also in question?<sup>142</sup>

Professor Mooney cites this history to support the proposition that “bank lenders were reluctant to extend credit necessary to provide vital liquidity because of uncertainty as to perfection and priority of security interests in collateral.”<sup>143</sup> The lessons to be drawn from DBL Group’s bankruptcy have been mischaracterized in two different ways. First, the pages he cites from Mr. Breeden’s prepared statement do not concern the causes of the bankruptcy. Rather, these pages discuss the subsidiary issue of what occurred in the “phased-windup of DBL’s activities” subsequent to the bankruptcy.<sup>144</sup> Second, Mr. Breeden’s statement identifies a number of problems arising from the windup, only one of which was a legal problem that Revised Article 8 addresses, the problem of the “effectiveness” of agreements to pledge.<sup>145</sup> And even this problem is not one that requires even a

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142. “Why would we lend money to the holding company?” one money-center executive asked. “It has no cash-generating capability.” Lisabeth Weiner & Jed Horowitz, *Bank Squeeze Forced Hand of Faltering Drexel Parent*, AM. BANKER, Feb. 14, 1990, at 1. See generally ARNOLD B. COHEN, GUIDE TO SECURED LENDING TRANSACTIONS § 2.04 (1988) (describing factors that secured lenders consider in making loans); RAYMOND T. NIMMER & INGRID MICHELSEN HILLINGER, COMMERCIAL TRANSACTIONS: SECURED FINANCING 10-15 (1992).

143. Mooney, *supra* note 114, at 315 n.13.

144. *Drexel Hearings*, *supra* note 125, at 49. Eighty-two percent of DBL’s securities holdings were sold between February 9 and 21, 1990. See Michael Siconolfi, *Drexel Has Sold 82% of Its Stock, Bonds Since Feb. 9*, WALL ST. J., Feb. 21, 1990, at C13.

145. See *Drexel Hearings*, *supra* note 125, at 49-50. Mr. Breeden identified two other problems. The first arose from uncertainty of DBL’s lenders about whether DBL had segregated on its books the securities it proposed to pledge. See *id.* at 50. Presumably the lenders were afraid that they would acquire only “the rights in the security which [DBL] had or had actual authority to convey.” 1977 OFFICIAL TEXT, *supra* note 4, § 8-301(1). The lender’s solution was “to require the recording of their interests in the collateral through DTC’s pledge program,” *Drexel Hearings*, *supra* note 125, at 50 (statement of SEC Chairman Richard C. Breeden), presumably to ensure that the lenders were bona fide purchasers that took free of adverse claims, see 1977 OFFICIAL TEXT, *supra* note 4, § 8-313 (2). The result of this “hard pledge” was to take “control of DBL’s inventory away from DBL and [to impede] DBL’s ability to settle liquidation trades.” *Drexel Hearings*, *supra* note 125, at 50 (statement of SEC Chairman Richard C. Breeden).

Although Revised Article 8 would make it easier for a lender to achieve a status equivalent to that of a bona fide purchaser, a prudent lender in a situation similar to the one involving DBL would still seek to protect itself by achieving “control” over the pledged securities. See *infra* Part VI. Although “control” under Revised Article 8 does not necessarily involve a transfer to the pledgee’s account, as contemplated by section 8-320(1) of 1977 Article 8, similar delays to those that occurred in the DBL windup could be expected whenever a pledgee insisted on controlling the disposition of collateral.

The second additional problem identified by Mr. Breeden is a purely commercial one to which no version of Article 8 is addressed:

[M]any banks became concerned over the valuation and liquidity of DBL’s junk bond portfolio, which was one portion of the collateral securing their loans. This led many of the banks to be unwilling to release any collateral to complete DBL liquidating transactions for fear that the replacement collateral would have an increasing concentration of junk bonds.

*Drexel Hearings*, *supra* note 125, at 50.

major revision to 1977 Article 8 to accomplish, much less the fundamental changes contained in Revised Article 8.

Finally, Mr. Breeden did identify the windup as posing “systemic risks,” which created threats to the “securities clearance and settlement system or the interbank payment systems.”<sup>146</sup> But even this explicit discussion of systemic risks, which occurred in a written response to questions posed by certain Senators, was only a reprise of Mr. Breeden’s earlier prepared statement. Nothing is added by the written response to make more convincing the argument that Revised Article 8 is necessary to forestall systemic risk.<sup>147</sup>

#### D. *The Market Reform Act of 1990*

Supporters of Revised Article 8 also often cite to the congressional reports on the Market Reform Act of 1990 as evidence that “the problem of potential and actual nonuniformity among the states . . . [is] the major problem with the commercial law foundation of the securities clearance and settlement system.”<sup>148</sup> The main legal problem actually identified in these reports was an inconsistency in state treatment of options as collateral, which “makes the financing process more burdensome for prospective lenders and may create enough

Mr. Breeden also discussed problems arising from settlements of mortgage-backed securities. *See id.* at 51-53. But the problems arose from commercial concerns of DBL’s counterparties that DBL might go bankrupt after receiving securities and prior to paying for them. *See id.* at 52. These are normal commercial concerns that would arise with respect to any potentially bankrupt counterparty and would not be alleviated by Revised Article 8.

146. *Id.* at 133 (Richard C. Breeden, Response to Written Questions).

147. In his written response, Mr. Breeden identified three systemic risks arising from the impact that the bankruptcy of DBL Group, the holding company parent, had on DBL, the broker-dealer subsidiary. The first risk was that DBL might have faced a liquidity crisis, which arose from normal commercial concerns on the part of DBL’s lenders, creditors, and counterparties, not from concerns about legal issues arising from Article 8. DBL’s “lenders, creditors, and counterparties . . . might insist on settling transactions [with DBL] only on a fully-collateralized basis, might accelerate open contractual commitments, and might refuse to deliver securities or funds in an orderly manner . . .” *Id.* These risks arose out of concerns that DBL might become insolvent before it met its obligations. In the market for GNMA mortgage-backed securities, for example, forward trades in coupons on GNMA securities settled in 1990 by “the seller delivering negotiable certificates to the buyer against payment of funds over Fedwire later that day.” *Id.* at 52. On February 14, 1990, DBL had net settlement obligations of \$346 million. *See id.* Not surprisingly, as February 14, 1990, was the day after DBL Group’s bankruptcy filing, DBL’s counterparties were not willing to take the risk that DBL might declare insolvency before making payment, *see id.*, and almost none of their trades settled.

This “run on DBL’s assets” in turn created the second risk, which was that DBL’s counterparties might not have been able to obtain payment or securities from DBL, depending on the nature of the transactions. *Id.* at 133. The third risk was related to the second. As settlement slowed in certain markets, financing costs for DBL’s counterparties would increase as settlement slowed down. “Thinly-capitalized, highly-leveraged, and badly positioned firms that did not have sufficient resources to withstand those losses or pay the carrying costs could be forced out of business” in the event that there were delays in DBL’s settlement of trades. *Id.*

148. Rogers, *supra* note 7, at 1542.

uncertainty to cause a prospective lender to reconsider its decision to accept options as collateral for loans.”<sup>149</sup> The Senate also identified the restrictions on “the ability of domestic clearing agencies to use foreign financial institutions and clearing agencies as custodians for their members’ securities,” which led investors to set up “a number of clearing and custodial relationships,” as a problem arising from 1977 Article 8.<sup>150</sup> The result was that no single clearing agency could “assess . . . the investor’s total financial exposure. This detracts from the liquidity of the clearance and settlement system by requiring a greater volume of money and securities settlements than may otherwise be necessary.”<sup>151</sup>

Even the congressional commitment to uniformity among the states was weak. Although the Market Reform Act amended the Exchange Act by adding section 17A(f), which grants the SEC the power through regulation to preempt state law concerning the transfer of interests in certain securities,<sup>152</sup> each state was allowed to individually opt out of any SEC promulgated rule concerning transfers of securities within two years of the promulgation of any such rule.<sup>153</sup>

Of course, the lack of an overarching justification for Revised Article 8 does not mean that it should have been rejected, merely that the case in its favor is weaker than its proponents would like it to be. Revised Article 8 makes a number of major changes in state law, however, that argue for significantly amending certain revised sections.

#### IV. BAD ACTOR TRANSFEREES

Revised Article 8 contains provisions covering both securities, whether certificated or uncertificated, and securities entitlements that are analogous to the provisions covering bona fide purchasers and adverse claims that are contained in section 8-302 of 1977 Article 8. The provisions covering securities in Revised Article 8 vary from those contained in 1977 Article 8 by dropping the “good faith” requirement for bona fide purchaser status and narrowing the definition of notice. Two additional important changes are present in the three revised provisions covering securities entitlements. All three provisions place the burden of proof on the party alleging that the

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149. HOUSE COMM. ON ENERGY AND COMMERCE, COORDINATED CLEARANCE AND SETTLEMENT ACT OF 1990, H.R. DOC. NO. 477, at 7 (1990). *Accord* SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, THE MARKET REFORM ACT OF 1990, S. DOC. NO. 300, at 63 (1990) [hereinafter 1990 SENATE REPORT].

150. 1990 SENATE REPORT, *supra* note 149, at 63.

151. *Id.* In other words, no netting of payment and delivery obligations was possible; therefore, the benefits of netting in reducing systemic risks, which are briefly described in *supra* Part III, were not available.

152. *See* 15 U.S.C. § 78q-1(f)(1) (1997).

153. *See id.* § 78q-1(f)(3).

transfer is wrongful, and all three, in different ways, severely limit the acts that will support a claim against a transferee. These changes were suggested in order to further the policy of post-settlement finality in securities transactions.<sup>154</sup> Before looking at the content of these changes, one general argument made by Professor Rogers in favor of these changes should be addressed.

Professor Rogers argues that favoring transferees of securities and securities entitlements over the beneficial owners is not a policy “that works to the [dis]advantage of investors or any other particular category of potential claimant.”<sup>155</sup> His basic point is that, in the event that a securities intermediary steals securities from a customer, the immediate transferee is likely to be a securities intermediary with investors as its customers and that any policy favoring beneficial owners will hurt the transferee securities intermediary’s customers.<sup>156</sup>

This argument ignores two things. First, as a practical matter, under 1977 Article 8, a beneficial owner almost always would have had a greater chance of recovering against his or her own securities intermediary rather than against the transferee. All of the difficult issues involved in tracing a transfer of indirectly held securities would have been avoided.<sup>157</sup> Usually, the beneficial owner is pursuing the transferee because the beneficial owner’s securities intermediary is insolvent or has declared bankruptcy.<sup>158</sup> As the immediate transferee is often another securities intermediary acting for itself or a customer,<sup>159</sup> any ultimate transferee that is a customer of a transferee securities intermediary would be protected. A transferee securities intermediary has an obligation to deliver the securities to its

154. See Rogers, *supra* note 7, at 1460-73, for an in-depth discussion of this policy.

155. *Id.* at 1516.

156. See *id.* at 1522-23.

157. See Schroeder, *supra* note 31, at 332-34.

158. See, e.g., *Wichita Fed. Sav. & Loan Ass’n v. Comark*, 610 F. Supp. 406, 408 (S.D.N.Y. 1985) (customers sued liquidating broker-dealer and its clearing broker); *In re Scott, Gorman Mun., Inc.*, 28 B.R. 659 (S.D.N.Y. 1983) (customer of bankrupt broker-dealer sued clearing broker).

159. The transferee also could be a traditional lender such as a bank, a purchaser in a repurchase agreement or a lender of securities to cover short positions that takes a security interest in other collateral securities. See Rogers, *supra* note 7, at 1527-29. Depending on the type of transferee, the transferee’s customers might suffer a real loss. But, under Revised Article 8’s statutory approach, individual investors who each hold a security entitlement would always be disadvantaged, while, under 1977 Article 8’s statutory approach, such individual investors only occasionally would be disadvantaged.

The generalization in the text also would not apply to the “rolodex market,” which consists of large institutions directly trading with each other. DIVISION OF MARKET REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY DEVELOPMENTS II-13 (1994) [hereinafter MARKET 2000] According to the SEC, “this activity does not appear to involve significant volume.” *Id.*

customer.<sup>160</sup> And as the transferee securities intermediary is not necessarily insolvent or bankrupt, its customer will only be negatively affected by the transferor beneficial owner pursuing the transferee securities intermediary if the transferee securities intermediary is rendered bankrupt by its obligation to make such a delivery.<sup>161</sup>

Second, certain categories of investors are infrequent traders. The typical individual shareowner, for example, engages in only a few stock transactions per year.<sup>162</sup> Insofar as the risk is that a securities intermediary may either mishandle or steal a financial asset that is held indirectly, it is more likely that an active trader, rather than an individual investor, will benefit from the extended finality rules of Revised Article 8.

#### V. THE DIRECT HOLDING SYSTEM AND PROTECTED PURCHASERS

For directly held securities, Revised Article 8 substitutes the term “protected purchaser” for “bona fide purchaser.”<sup>163</sup> Under Revised Article 8, a purchaser of a security can become a “protected purchaser” of such security if he/she “(1) gives value; (2) does not have notice of any adverse claim to the security; and (3) obtains control of the certificated or uncertificated security.”<sup>164</sup> 1977 Article 8 requires that a “bona fide purchaser” be “a purchaser for value in good faith and without notice of any adverse claim” that receives a security through certain defined means.<sup>165</sup> Some cases and commentators have treated “good faith” and “notice” as separate elements to proving bona fide purchaser status,<sup>166</sup> while others have treated “notice” as simply an

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160. See generally EGON GUTTMAN, MODERN SECURITIES TRANSFERS ¶¶ 8.02[2]-8.05 (4th ed. 1987) (describing obligations of broker-dealers to customers under 1962 Article 8 and 1977 Article 8, state common law, federal rules and self-regulatory organization (SRO) rules).

161. The shareholders of the transferee securities intermediary, of course, would suffer a loss. But this type of loss is exactly the type of risk to which it is appropriate to expose equity owners.

162. One 1989-90 survey found that 70.7% of individual shareowners traded two or fewer times per year, while another 1984-1985 survey found the same minimal level of trading by 55.3% of individual shareowners. MARKET 2000, *supra* note 159, at ex. 9.

163. Compare 1994 OFFICIAL TEXT, *supra* note 2, § 8-303(a), with 1977 OFFICIAL TEXT, *supra* note 4, § 8-302 (1).

164. 1994 OFFICIAL TEXT, *supra* note 2, § 8-303(a).

165. 1977 OFFICIAL TEXT, *supra* note 4, § 8-302(1).

166. See, e.g., First Nat'l Bank v. Lewco Sec. Corp., 860 F.2d 1407, 1413 (7th Cir. 1988) (“It must be stressed that section 8-302 imposes two independent requirements for a purchaser of securities to attain BFP status: the purchaser must take the securities in good faith, and without notice of adverse claims. These two requirements must not be confused or conflated . . .”) (citation omitted); Brian A. Blum, *Notice to Holders in Due Course and Other Bona Fide Purchasers Under the Uniform Commercial Code*, 22 B.C. L. REV. 203, 207 (1981) (“The U.C.C. requires that both good faith and lack of notice be established as a prerequisite for the status of bona fide purchaser and prescribes different standards for the determination of those separate elements.”).

element of proving good faith.<sup>167</sup> The issue becomes complicated because “good faith” is defined by the 1977 UCC as a subjective test,<sup>168</sup> while “notice” in the 1977 UCC contains an objective test as well.<sup>169</sup> Revised Article 8 in its notice definition removes any reasonable person standard and deletes any mention in revised section 8-303 of good faith as a requirement for protected purchase status.

#### A. “Notice”

The first change in Revised Article 8 from 1977 Article 8 is the narrowing of the “notice” definition in Revised Article 8. 1977 Article 8 relies on the general definition of notice in Part 1 of the UCC, which defines notice of a fact as both when a person “has actual knowledge of it” or “from all the facts and circumstances known to him at the time in question . . . has reason to know that it exists.”<sup>170</sup> Revised Article 8 creates a unique definition of “notice” when dealing with adverse claims. A reasonable person standard with regard to notice is rejected.<sup>171</sup> Notice of an adverse claim exists only if the transferee has actual knowledge of the adverse claim<sup>172</sup> or if the transferee is willfully blind to “information that might establish the existence of the adverse claim.”<sup>173</sup> In turn, in order to find willful blindness, two things must be established. First, it must be shown that “the person is aware of the facts sufficient to indicate that there is a *significant probability* that *the* adverse claim exists.”<sup>174</sup> It is not enough that a claim may exist; there must be a “significant probabil-

167. See, e.g., *Fidelity & Cas. Co. v. Key Biscayne Bank*, 501 F.2d 1322, 1326 (5th Cir. 1974) (“The ‘good faith’ and ‘without notice’ requirements are practically synonymous.”); ARTICLE 8 BAR REPORT, *supra* note 6, at 33 (“The concept of ‘good faith’ added nothing of value to the definition of ‘bona fide purchaser,’ as applied by New York courts, nor did it disclose any additional requirement for taking free of adverse claims under New York case law.”).

168. “Good faith’ means honesty *in fact* in the conduct or transaction concerned.” 1977 OFFICIAL TEXT, *supra* note 4, § 1-201(19), (emphasis added).

169. “A person has ‘notice’ of a fact when . . . from all the facts and circumstances known to him at the time in question he has *reason to know* that it exists.” 1977 OFFICIAL TEXT, *supra* note 4, § 1-201(25)(c) (emphasis added).

170. 1977 OFFICIAL TEXT, *supra* note 4, §§ 1-201(25)(a), (c).

171. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-105 cmt. 1.

172. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-105(a)(1) cmt. 3.

173. 1994 OFFICIAL TEXT, *supra* note 2, § 8-105(a)(2) cmt. 4. There is a third type of notice that arises if “the person 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.” 1994 OFFICIAL TEXT, *supra* note 2, § 8-105(a)(3) (emphasis added). This subsection covers a very limited range of situations. The duty must be one to investigate an adverse claim. Presumably the duty to know one’s customer, described in *infra* Part V.B., would not meet the criterion of revised subsection 8-105(a)(3). The comments indicate that an example of the type of duty covered by revised subsection 8-105(a)(3) is the duty of brokers and dealers under federal securities laws to check with a registry of stolen securities with respect to securities offered for sale or pledge. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-105(a)(3) cmt. 5.

174. *Id.* § 8-105(a)(2) (emphasis added).



ity” of its existence. Second, the person must “deliberately avoid[ ] information that would establish the existence of the adverse claim.”<sup>175</sup> Mere negligence, perhaps even gross negligence, would not meet this second prong. Revised Article 8 will make it very difficult, if not impossible, for a beneficial owner to prove that a transferee of a security took with knowledge of any adverse claim. This is a significant change from 1977 Article 8 as applied in most jurisdictions.<sup>176</sup>

New York had a nonuniform definition of notice of adverse claims,<sup>177</sup> which supporters of Revised Article 8 believe is comparable to the revised new definition.<sup>178</sup> In fact, the legal significance of this

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175. *Id.*

176. *See, e.g.,* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. City Nat'l Bank, 628 F.2d 969, 970 (6th Cir. 1980) (“The Uniform Commercial Code definition of ‘notice’ partakes of an objective standard by which the reasonableness of [the initial transferee’s] protestations that *nothing* about the transaction suggested impropriety to him must be judged.”); Oscar Gruss & Son v. First State Bank, 582 F.2d 424, 431 (7th Cir. 1978) (stating that “either actual or constructive notice will prevent one from obtaining the favored status of bona fide purchaser”); Miriani v. Rodman & Renshaw, Inc., 358 F. Supp. 1011, 1013-14 (N.D. Ill. 1973). *See generally* Blum, *supra* note 166, at 212-16 (describing constructive notice under the UCC).

177. “Except as provided in this section, to constitute notice of an adverse claim or a defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the security amounts to bad faith.” N.Y. U.C.C. LAW § 8-304(4) (McKinney 1990). Article 3 of the New York Uniform Commercial Code contains an almost identical provision in section 3-304(7): “In any event, to constitute notice of a claim or defense, the purchaser must have knowledge of the claim or defense or knowledge of such facts that his action in taking the instrument amounts to bad faith.” N.Y. U.C.C. LAW § 3-304(7) (McKinney Supp. 1997-1998).

178. *See* ARTICLE 8 BAR REPORT, *supra* note 6, at 18-19; Rogers, *supra* note 7, at 1536 n.156. While Pennsylvania does not have a nonuniform provision comparable to the New York’s 1977 Article 8, there is Pennsylvania case law interpreting section 8-304 of 1977 Article 8 in a manner consistent with the *Article 8 Bar Report’s* position. *See* Colin v. Cent. Penn Nat'l Bank, 404 F. Supp. 638, 640-42 (E.D. Pa. 1975), *aff'd*, 544 F. 2d 512 (3d Cir. 1976) (mem.). Only the actual knowledge of a person claiming bona fide purchaser status is relevant, not what a reasonable person should have known. *See id. But see* SEC v. Investors Sec. Corp., 415 F. Supp. 745, 756 (W.D. Pa. 1976), *rev'd on other grounds*, 560 F.2d 561 (3d Cir. 1977) (holding that a warning from a bank about a different transaction and other factual circumstances mandated inquiry in the instant transaction and, absent inquiry, the security holder acted in bad faith).

Although more recent Pennsylvania case law purports to adhere to this purely subjective standard, Pennsylvania courts have relied on section 8-318 of 1977 Article 8 to avoid the subjectivity of section 8-304. Section 8-318 provides that “[a]n agent or bailee who in good faith (including observance of *reasonable commercial standards* if he is in the business of buying, selling, or otherwise dealing with securities) has received securities and sold, pledged or delivered them according to the instructions of his principal is not liable for conversion.” 1977 OFFICIAL TEXT, *supra* note 4, § 8-318 (emphasis added).

In *Insurance Co. of N. Am. v. United States*, 561 F. Supp. 106 (E.D. Pa. 1983), a broker-dealer was held to the commercially reasonable standard under section 8-318 even though the court had determined that “in all trades for the Morris Carroll account Cannon [the broker-dealer] became a purchaser when it acquired the bearer securities for sale.” *Id.* at 113. Although the finding that Cannon became a purchaser would suggest the application of section 8-304, the court applied the standard provided for in section 8-318. Too much weight cannot be placed on this seeming anomaly because, when the facts are read carefully, it is unclear whether Cannon did, in fact, become a purchaser.

nonuniform addition is unclear. There is ample precedent to support the proposition that, at least for brokers, New York's definition of notice for Article 8 purposes was not materially different from that of other states.<sup>179</sup> This line of cases holds brokers to a higher standard of "good faith" than other purchasers, one that encompasses more than actual knowledge or willful blindness.

In 1962, New York added a nonuniform subsection 8-304(3),<sup>180</sup> which was renumbered as (4) when Article 8 was amended in 1977, in New York. Even before there was New York case law interpreting the nonuniform provision, one influential commentator had expressed the opinion that, in view of "the cases cited in the Official Comment to this section [8-304], several of which, decided in New York, appear to impose a somewhat higher standard of 'good faith' upon a 'professional' purchaser, e.g., a bank or broker," it "is problematical" to what "extent, if any, . . . decisions under this section will vary from those in other states."<sup>181</sup>

This prediction bore fruit in 1967, when the New York Court of Appeals decided *Hartford Accident & Indemnity Co. v. Walston & Co.*<sup>182</sup> The defendant broker was sued for conversion after the defendant had sold shares of stock stolen from Bache & Co., which assigned its interest in the shares to the plaintiff.<sup>183</sup> The Court of Appeals relied on Rule 405 of the New York Stock Exchange<sup>184</sup> to hold

There is no such ambiguity in the incorporation of an objective standard in *City of Shamokin v. West End Nat'l Bank*, 29 Pa. D. & C.3d 338 (Pa. Com. Pl. 1983). After determining that the bank had acted as a purchaser in the transaction in question, the court recognized that good faith focused on subjective intent only. The court then immediately noted that "requirements in addition to 'honesty in fact' are required for 'good faith' under other provisions of the Code," referring to section 8-318, and concluded that "since the bank is in the business of dealing with securities, the objective good faith standard of observing reasonable commercial standards should apply." *Id.* at 344.

179. See, e.g., *Hartford Accident & Indem. Co. v. Walston & Co.*, 234 N.E.2d 230, 235 (N.Y. 1967); *Berlitz Int'l, Inc. v. Macmillan, Inc.*, N.Y. L.J., Apr. 24, 1997, at 28 (N.Y. Sup. Ct. 1997).

180. See Uniform Commercial Code, 1962 N.Y. LAWS 553, at § 8-304(3). The language of subsection 8-304(3) was amended, in ways that are not material for this discussion, in 1964. 1964 N.Y. LAWS 476, § 8. Since 1964, other than in its renumbering, the language of subsection 8-304(3) has not changed.

181. Carlos L. Israels, Practice Commentary, N.Y. U.C.C. § 8-304 (McKinney 1964).

182. 234 N.E.2d 230 (N.Y. 1967).

183. See *id.* at 233. Presumably the plaintiff was Bache & Co.'s insurance company.

184. In 1967, Rule 405 required that a broker must "use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried." *Id.* at 233 (quoting Rule 405). The Rule's wording has not been changed since 1967. See NYSE Rule 405, reprinted in 2 N.Y.S.E. GUIDE (CCH) ¶ 2405 (1995).

Similar "know your customer" rules have been promulgated by other self-regulatory organizations. See, e.g., American Stock Exchange Rule 411, reprinted in 2 AM. STOCK EX. GUIDE (CCH) ¶ 9431 (1995) (establishing due diligence, approval, and notice requirements for members and member organizations); section 27 of the Rules of Fair Practice of the National Association of Securities Dealers, reprinted in NASD DEALERS MANUAL (CCH) ¶ 3010 (1995). See generally *The "Know Your Customer" Rule of the NYSE: Liability of Broker-Dealers Under the UCC and Federal Securities Laws*, 1973 DUKE L.J. 489 (1973).

that the defendant could not have acted in “good faith” unless “in receiving and selling the shares for the account of [the thief or his or her confederate] . . . it observed reasonable commercial standards, which included the exercise of due diligence to learn the essential facts relative to this customer, his account and these sales orders.”<sup>185</sup> As *Walston* was a case that arose prior to the effective date of Article 8 in New York, it was decided under New York’s version of the Uniform Stock Transfer Act, which was contained in the Personal Property Law. But the New York Personal Property Law included a bona fide purchaser provision that was very similar to that contained in section 8-304 of the UCC.<sup>186</sup> In addition, the *Walston* court made reference to section 8-318 of the UCC and implied that the result would have been no different if that section of the UCC had applied.<sup>187</sup>

The reference to section 8-318 in *Walston* should alert the reader to one of the paradoxes of the reading of section 8-304 advocated by supporters of Revised Article 8. Section 8-304 deals with when purchasers have notice of adverse claims, while section 8-318 protects agents and bailees from liability for “conversion or for participation in breach of fiduciary duty.”<sup>188</sup> To obtain the shelter of section 8-318, the agent or bailee must have acted in “good faith,” which “includ[es] observance of reasonable commercial standards if he is in the business of buying, selling or otherwise dealing with securities.”<sup>189</sup> Depending on the factual circumstances of a transfer of a security under 1977 Article 8, a broker-dealer can be a “broker”<sup>190</sup> or just an intermediary, “e.g. when it transfers securities on a customer’s instructions, either without charge or for a nominal handling charge.”<sup>191</sup>

New York did not adopt a nonuniform provision for section 8-318 as it had for section 8-304. If the supporters of Revised Article 8 are correct in their reading of section 8-304 in 1977 New York Article 8,

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185. *Walston*, 234 N.E.2d at 237. The only attempt the defendant made to identify the individual who delivered the stolen certificates for sale was to examine

‘one or two cards’ with the name Jack Arbetell [name used by the individual] on them. The best recollection of the witness [the defendant’s customer’s man] was that one of the cards was a business card. He did not recall what the other one was. This was the only evidence of identification that was produced.

*Id.* at 233.

186. Compare N.Y. PERS. PROP. LAW § 168 (McKinney 1962) (repealed 1964) with N.Y. U.C.C. LAW § 8-304(4) (McKinney 1990).

187. See *infra* text accompanying notes 190-94 for further discussion.

188. 1977 OFFICIAL TEXT, *supra* note 4, § 8-318.

189. *Id.*

190. A “broker” is defined as “a person engaged for all or part of his time in the business of buying and selling securities, who in the transaction concerned acts for, buys a security from, or sells a security to, a customer.” *Id.* § 8-303. Even when a “broker” is not a purchaser of a security for UCC purposes, i.e., it did not acquire “an interest in” the security, see *id.* §§ 1-201 (22), (23), the broker can be a purchaser under section 8-304 for notice of adverse claims purposes, see *id.* § 8-304 cmt. 5. A broker also has the “rights and privileges of a purchaser under” section 8-306 of 1977 Article 8. *Id.* § 8-306(10).

191. *Id.* § 8-306 cmt. 4.

it would have been possible for an agent or bailee without actual notice of an adverse claim and that had received no or nominal compensation to be liable for conversion under section 8-318 for activities that would not have endangered the bona fide purchaser status of a broker who was receiving a normal commission on an agency transaction. This reading of section 8-304 and 8-318 in 1977 New York Article 8 would have exposed agents and bailees to higher risks than UCC “brokers.”

The fact that the *Walston* court explicitly construed the term “good faith” is important in evaluating whether, under New York law, the good faith requirement added anything to the concept of notice. The *Walston* court did not discuss notice or equate good faith with notice,<sup>192</sup> both of which one would expect if Revised Article 8’s proponents are correct that there is no functional difference between these two concepts under New York law.<sup>193</sup> The *Walston* holding remains good law in New York.<sup>194</sup>

In fairness to the *Article 8 Bar Report*, precedent exists that either questions the *Walston* holding<sup>195</sup> or directly supports the report’s in-

192. 234 N.E.2d at 235. In the language relevant to this discussion, sections 8-318 of 1977 Article 8 and 1962 Article 8 are identical. Both provide that an “agent or bailee” is “not liable for conversion or for participation in breach of fiduciary duty although the principal had no right” to transfer a security when the agent or bailee acted “in good faith (including observance of reasonable commercial standards if he is in the business of buying, selling, or otherwise dealing with securities”). 1977 OFFICIAL TEXT, *supra* note 4, § 8-318; 1962 OFFICIAL TEXT, *supra* note 4, § 8-318. The *Walston* court did not discuss section 8-302 of the UCC or the nonuniform New York addition to section 8-304. See *infra* text accompanying notes 207-10 for a further discussion of the relationship between sections 8-318 and 8-302.

193. See ARTICLE 8 BAR REPORT, *supra* note 6, at 33; Rogers, *supra* note 7, at 1536 n.156.

194. See *United States Fidelity & Guar. Co. v. Royal Nat’l Bank*, 545 F.2d 1330, 1334-35 (2d Cir. 1976); *FDIC v. Lewellyn*, No. 82 Civ. 2311 (CBM), 1985 WL 1401, at \*5 (S.D.N.Y. May 21, 1985); *Cumis Ins. Soc’y v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1389 (S.D.N.Y. 1978); *Berlitz Int’l, Inc. v. Macmillan, Inc.*, N.Y. L.J., Apr. 24, 1997, at 28 (N.Y. Sup. Ct. 1997). *Cf. Bagby v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 348 F. Supp. 969, 976-77 (W.D. Mo. 1972) (applying NYSE Rule 405 to determine whether defendant was negligent under section 3-406 of the Missouri UCC), *aff’d in part, rev’d in part on other grounds*, 491 F.2d 192 (8th Cir. 1974); *Fidelity & Deposit Co. v. Chemical Bank*, 318 N.Y.S.2d 957, 959 (N.Y. App. Div. 1970) (applying Rule 405 in a case involving Article 3). *But cf. Aetna Cas. & Surety Co. v. Paine, Webber, Jackson & Curtis*, [1969-70 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,748, at 99, 274-75 (N.D. Ill. Apr. 7, 1970) (holding that interpreting Rule 405 to require investigation of title or ownership of stock certificates endorsed in blank is not consistent with New York case law).

195. In *Royal National Bank*, the court expressed some skepticism about whether *Walston* was correct in incorporating Rule 405 as “reasonable commercial practice” under New York law. 545 F.2d at 1335 n.2. The court implied that, absent a recognized private cause of action, the incorporation of the Rule 405 standard was not warranted. See *id.*

The federal courts are split as to whether there is a private federal cause of action pursuant to NYSE Rule 405. Compare *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141-43 (7th Cir. 1969) (the first case to imply a private federal cause of action for violations of “know your customer” rule), and *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989) (holding that a private cause of action exists for viola-

terpretation of New York law.<sup>196</sup> In addition, the 1964 prediction that all professional dealers in securities would be held to a more exacting definition of notice has not borne much fruit. The reported cases finding such a higher duty almost entirely deal with brokers who are subject to Rule 405.<sup>197</sup>

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tions of the “know your customer” rule), and *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977) (holding that a private cause of action exists for violations of the “know your customer” rule), *aff’d in part, remanded on other grounds*, 579 F.2d 38 (2d Cir. 1978), and *Faturik v. Woodmere Secs., Inc.*, 442 F. Supp. 943, 946 (S.D.N.Y. 1977); with *In re VeriFone Secs. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993) (“It is well established that violation of an exchange rule will not support a private claim.”), and *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990) (holding that NYSE Rule 405 does not imply a private federal cause of action), and *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981) (holding that NYSE Rule 405 does not imply a private federal cause of action), and *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 680 (9th Cir. 1980) (holding that NYSE Rule 405 does not imply a private federal cause of action), and *Birotte v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 468 F. Supp. 1172, 1179 (D.N.J. 1979) (holding that NYSE Rule 405 does not imply a private federal cause of action), and *Piper, Jaffray & Hopwood, Inc. v. Ladin*, 399 F. Supp. 292, 297 (S.D. Iowa 1975) (holding that NYSE Rule 405 does not imply a private federal cause of action).

Many of the courts that find that the NYSE or NASD rules do not create a private cause of action still incorporate the standards established by those rules into other causes of action under either the federal securities laws or applicable state law. These courts use violations of the NYSE and NASD rules as indicia of the behavior or intent necessary to prove other violations under these laws. See *Miley*, 637 F.2d at 333 (holding that, although there was no private cause of action for violations of NYSE and NASD rules, the jury could consider a violation as a factor in determining if plaintiff’s account had been excessively traded); *Birotte*, 468 F. Supp. at 1179 (holding that, although there is no private federal cause of action for violation of Rule 405, “[t]his is not to conclude, however, that violation of Rule 405 might not be evidential, if relevant, to prove fraud alleged in a claim made under Rule 10b-5”); *Ladin*, 399 F. Supp. at 298 (“Both Rule 405 of the NYSE and the NASD Suitability Rule are appropriate indicia of the standard of conduct required of a stock broker in the practice of his profession.”). For Article 8 analysis, it should be irrelevant, therefore, whether a private cause of action exists under various SRO rules such as Rule 405.

196. See ARTICLE 8 BAR REPORT, *supra* note 6, at 18-19 (discussing two federal cases applying New York law and two pre-UCC New York cases). None of the four cases cited in the *Article 8 Bar Report* involved brokers, subject to Rule 405 or other similar “know your customer” rules, making bona fide purchaser defenses. See *Gutekunst v. Continental Ins. Co.*, 486 F.2d 194, 195 (2d Cir. 1973) (bank); *In re Lion Capital Group*, 49 B.R. 163, 169 (Bankr. S.D.N.Y. 1985) (trust company); *Hall v. Bank of Blasdell*, 118 N.E.2d 464, 466 (N.Y. 1954) (bank); *Manufacturers & Traders Trust Co. v. Sapowitch*, 72 N.E.2d 166, 167 (N.Y. 1947) (trust company). Nor did any of these four cases discuss either Rule 405 or any similar “know your customer” rule. The *Article 8 Bar Report* also could have cited to *Macmillan Inc. v. Bishopgate Investment Trust*, 1995 W.L.R. 978 (Ch.), *aff’d on other grounds*, 1996 W.L.R. 388 (C.A.), where Justice Millett construed 1977 New York Article 8’s test of good faith to be “actual knowledge or suspicion and deliberate abstention from inquiry lest the truth be discovered, not reason to know or cause to suspect.” *Id.* at 987. *Bishopgate*, however, also did not involve any brokers subject to Rule 405 or other similar know your customer rules. See *Berlitz*, N.Y. L.J., Apr. 24, 1997, at 28. See Joseph H. Levie, “*Macmillan*”: *English Court Rules on New York UCC*, N.Y. L.J., Jan. 13, 1994, at 5, for a discussion of *Macmillan*, including additional quotations on the notice issue that are not available in the edited version of Justice Millett’s opinion in *The Weekly Law Report*.

197. See *Berlitz*, N.Y. L.J., Apr. 24, 1997, at 28 (distinguishing good faith required of defendants in a prior related case, which were professional participants in overseas securities markets but not members of the NYSE, from that required of a defendant in *Berlitz*, which was a “securities broker and a member . . . of the New York Stock Exchange,” and

### B. "Good Faith"

The second major change made by Revised Article 8 is the deletion of the requirement that the protected purchaser have acted in "good faith." The *Article 8 Bar Report* argues that this deletion does not change New York law,<sup>198</sup> while Professor Rogers concedes that prior law may be changed but argues that the change is necessary in order to minimize confusion.<sup>199</sup> Those courts that treat good faith as a separate requirement from notice for bona fide purchaser status often use good faith as a means to examine circumstances surrounding a transfer that shed light on the "subjective intent with which the purchaser acted."<sup>200</sup> Even where the purchaser has no actual or constructive notice of an adverse claim, circumstances that indicate "something was wrong" may deprive the purchaser of its status as a bona fide purchaser.<sup>201</sup>

As with the notice issue, the New York case law can be read to support either the position that notice and good faith are separate

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thus held to "a more stringent standard" of good faith). *Cf.* *Chemical Bank v. Haskell*, 411 N.E.2d 1339, 1342 (N.Y. 1980) (stating that, in an Article 3 case, "suspicious circumstances which might well have induced a prudent banker to investigate more thoroughly" were not enough to jeopardize bona fide purchaser defense). *In re Legel Braswell Gov't Secs. Corp.*, 695 F.2d 506 (11th Cir. 1983), is an exception to this generalization. The *Legel Braswell* court applied section 8-304(3) of 1962 New York Article 8, the predecessor to section 8-304(4) of 1977 New York Article 8, relying in part on "Irving Trust's status as a commercial bank," to hold that "Irving Trust's disregard for suspicious circumstances, of which it had actual knowledge, constituted a taking in bad faith." *Id.* at 513-14.

198. See ARTICLE 8 BAR REPORT, *supra* note 6, at 33.

199. See Rogers, *supra* note 7, at 1469-73. Although Professor Rogers notes that some courts have interpreted 1977 Article 8 as imposing a separate good faith requirement from the notice of adverse claims requirement, see *id.* at 1469 n.55, his personal view is that the better reading of the linguistic sources of the phrase and its use in prior cases indicates that good faith does not impose a separate requirement from that of notice. See *id.* at 1469-73. Professor Rogers does not specifically discuss New York Article 8 at this point. He later mentions nonuniform section 8-304(4) in passing while discussing collusion, misstating New York's law on notice in much the same way that the *Article 8 Bar Report* does. See *id.* at 1536 n.156.

200. *Oscar Gruss & Son v. First State Bank*, 582 F.2d 424, 432 (7th Cir. 1978). See generally Gregory C. Yadley & Atilla S. Ilkson, *Bona Fide Purchasers of Lost and Stolen Securities: Meeting the "Good Faith" and "Notice" Requirements*, 5 GEO. MASON L. REV. 101, 108-17 (1982) (discussing cases applying suspicious circumstances concept).

201. *Oscar Gruss*, 582 F.2d at 432 (finding that there was no notice but that there was a strong inference that facts indicated lack of good faith). *Accord* *SEC v. Investors Security Corp.*, 415 F. Supp. 745, 756 (W.D. Pa. 1976) (stating that even where there is no notice, "[f]rom all the facts and circumstances which were known . . . inquiry . . . [may be] required" in order to establish bona fide purchaser status), *rev'd on other grounds*, 560 F.2d 561 (3d Cir. 1997). See generally Egon Guttman, *Mediating Industry and Investor Needs in the Redrafting of UCC Article 8*, 28 UCC L.J. 3, 31 (1995) ("Although the proposed revisions of Article 8 reject the concept of constructive notice binding securities intermediaries, a purchaser who ignores warning signs may be unable to claim to be in good faith. But can it be alleged in all instances that there is knowledge or notice including constructive notice?").

elements for bona fide purchaser status<sup>202</sup> or the position of the *Article 8 Bar Report*.<sup>203</sup> The splits in the New York case law suggest that there is no legal consensus on the type of notice of adverse claims that is appropriate under Article 8 or on whether there is a difference between good faith and notice. A justification for the tightening of the notice standards or the discarding of good faith in Revised Article 8 has to be found in policy arguments rather than in reliance upon precedent. Regrettably, neither Professor Rogers nor the *Article 8 Bar Report* explicitly put forward policy arguments for these two changes. It is certainly true that it would not be appropriate to impose new, higher standards requiring frequent investigation by transferees. Such standards would impede the free transferability of securities.<sup>204</sup> However, this does not necessarily mean that the current standards should be lowered as they are in Revised Article 8.

### C. Implications

The notice standards embodied in 1977 Article 8 have not led to significant confusion in their application. Commentators have been able to formulate clear guidelines to regulate the behavior of participants in American securities markets.<sup>205</sup> Parallel guidelines exist for good faith behavior.<sup>206</sup> In addition, the weakening of notice standards combined with the dropping of the good faith requirement raises the issue of what restraints there would be on market participants. Under 1977 Article 8, a transferee must be concerned about constructive notice of adverse claims or about suspicious circumstances, which should make a transferee attentive to the business practices of the transferor. This attentiveness is necessary to provide a shield from

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202. See, e.g., *Otten v. Marasco*, 353 F.2d 563, 565 (2d Cir. 1965) (“[I]t is clear that failure to inquire may under certain circumstances constitute bad faith under New York law.”); *Garner v. First Nat’l City Bank*, 465 F. Supp. 372, 383 n.15 (S.D.N.Y. 1979) (stating that it is not necessary to hold that a defendant had knowledge of adverse claim to deny bona fide purchaser status; it is enough if “suspicious circumstances” existed).

203. See, e.g., *Gutekunst v. Continental Ins. Co.*, 486 F.2d 194, 196 (2d Cir. 1973) (stating “the clear rule set forth in New York decisions” and section 8-304(3) of 1962 New York Article 8 is that “it is not ignorance, but guilty knowledge or conduct that can be equated with guilty knowledge, that can rise to bad faith”); *Chemical Bank v. Haskell*, 411 N.E.2d 1339, 1342 (N.Y. 1980) (stating that in a case under Article 3, “suspicious circumstances which might well have induced a prudent banker to investigate more thoroughly” are not enough to jeopardize bona fide purchaser status); *Hall v. Bank of Blasdell*, 118 N.E.2d 464, 467 (N.Y. 1954) (stating that in a case under Negotiable Instruments Law, the “existence of merely suspicious circumstances does not, without more, amount to notice of an infirmity or defect”). The *Article 8 Bar Report* cites *Benjamin Ctr. v. Hampton Affiliates, Inc.*, 482 N.Y.S.2d 514, 515 (App. Div. 1984), *aff’d and modified on other grounds*, 488 N.E.2d 828 (N.Y. 1985), which does not discuss the issue of suspicious circumstances and, therefore, does not supply much support for the *Article 8 Bar Report’s* position.

204. See Rogers, *supra* note 7, at 1471.

205. See, e.g., Yadley & Ilkson, *supra* note 200.

206. See *id.*

liability under either section 8-302 (bona fide purchaser) or 8-318 (no conversion for good faith conduct by agent or bailee).

Weakening the incentive to transferee attentiveness puts increased weight on federal regulation of broker-dealers as the primary means of disciplining bad actor transferees who are negligently or intentionally jeopardizing the property rights of beneficial owners of securities.<sup>207</sup> This policy choice to favor federal regulation is criticized in Part VIII of this Article. The immediate transferee in the indirect holding system is usually either a financial institution itself or a financial institution acting as an agent, in either case possessing extensive knowledge of the relevant market practices and participants.<sup>208</sup> Who better to police transferors?<sup>209</sup>

207. See *infra* Part IV for further discussion.

208. Ironically, exactly this principle was proposed by the SEC and the SROs in connection with clearing brokers acting on behalf of introducing brokers. See Michael Siconolfi, *Heat Rises on Wall Street 'Clearing' Operations*, WALL ST. J., June 17, 1997, at C1. The collapse of A.R. Baron & Co., a small brokerage, in July 1996 was the catalyst for examining the duties of clearing brokers. See Diana B. Henriques & Peter Truell, *Should a Clearing-House Be Its Broker's Keeper? Queries For Bear Stearns After a Firm Fails*, N.Y. TIMES, Apr. 23, 1997, at D1. A number of legal actions were commenced against Bear Stearns Companies, which had cleared trades for over 3,000 accounts for A.R. Baron, alleging that Bear Stearns knew about unauthorized trades and sales misrepresentations involving these accounts but continued to do a clearing business with A.R. Baron. See *id.* In turn, the SEC and the Manhattan District Attorney's office commenced investigations of Bear Stearns' role. See Patrick McGeehan & Michael Siconolfi, *New Rules Expected on Clearing: More Responsibility Seen for Big Firms*, WALL ST. J., June 4, 1997, at C1.

Ultimately, the SROs decided to propose imposing reporting requirements on clearing brokers without requiring "an affirmative duty for clearing firms to report to regulators suspicious activity at their introducing brokers." Betty Santangelo & Marc E. Elovitz, *Proposed Rules Regarding the Responsibilities of Securities Clearing Firms for Their Introducing Brokers*, SCHULTE ROTH & ZABEL LLP SECURITIES LAW DEVELOPMENTS, Fall 1997, at 1, 2. The NYSE has proposed an amendment to its Rule 382 to make clearing brokers responsible for forwarding complaints of an introducing broker's customers to the appropriate regulator; creating mechanisms for introducing firms to request certain reports "to assist the introducer in supervising and monitoring customer accounts"; requiring the clearing broker to maintain these reports; and requiring the introducing broker to "represent to the carrying organization that it has supervisory procedures in place, which it enforces and which are *satisfactory to the carrying organization*, with respect to the issuance of [negotiable] instruments" by introducing brokers to their customers. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc., to Amend its Rule 382 Relating to Carrying Agreements, Exchange Act Release No. 34-39200 (Oct. 10, 1997), 62 Fed. Reg. 53,369, 53,370 (1997) (emphasis added). NASD is considering a similar rule. See Self-Regulatory Organization; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. to Amend its Rule 3230 Relating to Clearing Agreements, Exchange Act Release No. 34-39349 (Nov. 28, 1997), 62 Fed. Reg. 63,589 (1997).

It is of course possible that these reporting and record keeping obligations will be liberally interpreted to require reporting by clearing brokers of suspicious activity. See Santangelo & Elovitz, *supra*, at 2; see also Confirmation of Transaction Under Unfixed Commissions, Exchange Act Release No. 34-11629 (Sept. 3, 1975), 7 SEC Docket 782 (in situations involving potential violations by an institution of its fiduciary duty to its customers, noting that a broker acting on behalf of such institution "would have a duty of inquiry with respect to his participation in a cause of conduct which, to a reasonable person, would raise a question of fraudulent or deceptive acts or practices"). The Financial Crimes Enforcement



## VI. THE INDIRECT HOLDING SYSTEM

A. *Favored Purchasers*

Revised Article 8 does not use a term comparable to “protected purchaser” to describe a protected transferee under the indirect holding system. Rather, it provides that an adverse claim to a financial asset may be “asserted” only against a person who (a) “acquires a security entitlement,”<sup>210</sup> (b) *purchases* a “financial asset or an interest therein,”<sup>211</sup> or (c) “*purchases* a security entitlement, or an interest therein, from an entitlement holder,”<sup>212</sup> if the claimant can prove that certain stringent conditions have been met. Revised section 8-510 deals with purchases from an entitlement holder, while revised sections 8-502 and 8-503 deal with a purchase from a securities intermediary. On the face of the statute there is a conflict between the standards for favored purchaser status in revised sections 8-502 (notice) and 8-503 (collusion).<sup>213</sup> The Official Comments attempt to resolve this difference in favor of collusion.<sup>214</sup> This Article will refer to

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Network of the Department of Treasury may propose similar reporting requirements. See Santangelo & Elovitz, *supra*, at 4.

In response to micro-cap fraud, New York Attorney General Dennis C. Vacco proposed additional measures to require clearing brokers to monitor introducing brokers. See BUREAU OF INVESTOR PROTECTION AND SECURITIES, NEW YORK STATE ATTORNEY'S OFFICE, REPORT ON MICRO-CAP STOCK FRAUD 133-36 (1997). Other states have also focused regulatory resources on examining clearing brokers because of concerns about micro-cap fraud. See, e.g., Rachel Witmer, *Oppenheimer Gives Access to Records After Utah Regulators Suspend License*, 30 SEC. REG. & L. REP. (BNA) 135 (Jan. 23, 1998) (describing developments in Utah).

This regulatory approach was presaged by some court decisions that have held clearing brokers liable to customers of introducing brokers under legal theories of control or aiding and abetting for the actions of introducing brokers. See William J. Fitzpatrick & Ronald T. Carman, *An Analysis of the Business and Legal Relationship Between Introducing and Carrying Brokers*, 40 BUS. LAW. 47 (1984). The trend, however, has been to recognize that only a contractual relationship between the clearing broker and the introducing broker's customer can provide a basis for liability. See Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841 (1993).

209. Revised Article 8 does maintain the transferee incentive to guard against transfers of nonexistent financial assets. This is obviously true where a transferee is trading for its own account, but it is also true where the financial asset is held on behalf of an entitlement holder. In the latter case, the transferee has an obligation to “obtain and maintain” the financial asset for the entitlement holder. 1994 OFFICIAL TEXT, *supra* note 2, § 8-504 (a). The incentive to guard against transfers of assets upon which there are adverse claims is much weaker.

210. 1994 OFFICIAL TEXT, *supra* note 2, § 8-502 (emphasis added).

211. *Id.* § 8-503(e) (emphasis added).

212. *Id.* § 8-510(a) (emphasis added).

213. Professor Rogers attempts to minimize the difference between the notice and collusion standards by attributing the lack of uniformity to “the ordinary dynamics of any deliberative process involving large numbers of persons having different views and perspectives.” Rogers, *supra* note 7, at 1535. The differing values contained in these “different views and perspectives” are not explored further by Professor Rogers.

214. The Official Comments state:

purchasers against whom these conditions cannot be proved as “favored purchasers” in order to distinguish them from the defined term “protected purchasers.” In addition, a secured creditor of a securities intermediary is in a position analogous to that of a favored purchaser when the secured creditor is in control of a financial asset.

### 1. *Recovery Barriers*

The first substantive change from prior law is common to revised sections 8-502, 8-503 and 8-510, all of which deal with favored purchasers. The claimant alleging that the transfer is wrongful now bears the burden of proof.<sup>215</sup> In contrast, under prior law the burden was placed on the transferee claiming bona fide purchaser status.<sup>216</sup>

Beyond shifting the burden of proof for wrongful conduct to the claimant, revised sections 8-502, 8-503 and 8-510 erect additional substantial barriers to recovery from a transferee. First, the proposed definition of “notice” for the indirect holding system, which is relevant to revised sections 8-502 and 8-510 but not to revised section 8-503, is identical to that for certificated and uncertificated securities. The restrictive subjective meaning of “notice”<sup>217</sup> also will apply, therefore, to transferees of securities entitlements. Second, revised sections 8-502 and 8-510 require notice of the *particular* adverse claim that is asserted in order for a purchaser to lose its favored status.<sup>218</sup> In contrast, 1977 Article 8 requires that a bona fide

The rule of subsections (d) and (e) [of § 8-503] takes precedence over the general cut-off rules of these sections [§§ 8-502 and 8-510], because Section 8-503 itself defines and sets limits on the assertion of the property interest of entitlement holders. Thus, the question of whether entitlement holders’ property interest can be asserted as an adverse claim against a transferee from the intermediary is governed by the collusion test of Section 8-503(e), rather than by the “without notice” test of Sections 8-502 and 8-510.

1994 OFFICIAL TEXT, *supra* note 2, § 8-503 cmt. 2.

215. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-503 cmt. 3; ARTICLE 8 BAR REPORT, *supra* note 6, at 42. Although both the Official Comment to revised section 8-503 and the *Article 8 Bar Report* refer only to revised section 8-503 when discussing the burden of proof, all three proposed sections dealing with favored purchasers have the same structure to their language, i.e., that an action based upon the type of property that is the subject of the pertinent section may not be “asserted” against a certain type of purchaser. It seems likely that courts will interpret this language consistently for all three revised sections.

216. See, e.g., *Oscar Gruss & Son v. First State Bank*, 582 F.2d 424, 433 (7th Cir. 1978) (applying Illinois UCC); *Garner v. Pearson*, 545 F. Supp. 549, 558 (M.D. Fla. 1982) (applying Florida UCC).

217. See *supra* Part V.A.

218. See 1994 OFFICIAL TEXT, *supra* note 2, §§ 8-502, 8-510(a) (both revised sections use the phrase “the adverse claim”) (emphasis added). This was an inadvertent change in early drafts that Professor Rogers noticed when preparing the Proposed Final Draft. See 71 A.L.I. PROC. 233 (1994) (comments of Professor James S. Rogers). When Professor Rogers proposed changing back to the “any adverse claim” approach of 1977 Article 8, the Drafting Committee and Advisers wanted to keep the new language because “there’s a lot to be said for making the rules claim-specific; that, if an adverse claimant wants to assert a claim

purchaser be without notice of “*any* adverse claim.”<sup>219</sup> Therefore, knowledge of a claim other than the one being asserted against the transferee will not count in determining favored purchaser status. As Professor Egon Guttman has so aptly stated, this limitation on the type of adverse claim creates “an unsurmountable [sic] burden” for a person attempting to prove that a transferee is not a favored purchaser.<sup>220</sup>

The justification given in the Official Comments for this change is particularly weak. The Official Comments explain that “a particular entitlement holder’s interest in the financial assets held by its intermediary is necessarily ‘subject to’ the interest of others;” therefore, reference must be made to a specific adverse claim rather than to adverse claims in general.<sup>221</sup> Why Revised Article 8 could not have made a specific exception from the definition of adverse claim for the pro rata interests of other entitlement holders is never explained. Such an exception would have avoided the broadening of the protection given favored purchasers under revised sections 8-502 and 8-510.

A greater barrier to recovery from a transferee under Revised Article 8 is created by the very definition of a “securities entitlement.” As described above,<sup>222</sup> a securities entitlement is not a property interest in a particular financial asset; therefore, it is extremely unlikely that an investor in the indirect holding system will ever be able to prove that he or she has any interest in any particular financial asset. Comments to revised section 8-502 explore this result. As comment 2 describes and as comment 3 illustrates in a number of examples, it will normally be impossible for anyone to “trace the path of any particular security” that is cleared and settled in the indirect holding system;<sup>223</sup> therefore, it will usually be impossible for anyone even to make an equitable argument for recovery against a transferee.<sup>224</sup>

Revised section 8-503 describes the favored purchaser status of purchasers of financial assets in comparison to that of acquirers or purchasers of securities entitlements described in revised sections 8-502 and 8-510. If the barriers to disproving a transferee as a favored purchaser would be high under revised section 8-502, they would be virtually insurmountable under revised section 8-503. Instead of re-

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against someone, the claimant should show that someone had the necessary awareness of that claim and not be able to dredge up questions about something else.” *Id.* at 234.

219. 1977 OFFICIAL TEXT, *supra* note 4, § 8-302(1) (emphasis added).

220. Guttman, *supra* note 201, at 24.

221. 1994 OFFICIAL TEXT, *supra* note 2, § 8-502 cmt. 1.

222. *See supra* Part II.B.

223. 1994 OFFICIAL TEXT, *supra* note 2, § 8-502 cmts. 2, 3.

224. *See* 1994 OFFICIAL TEXT, *supra* note 2, § 8-502 cmt. 3, exs. 4, 5 (describing tracing arguments as implausible).

quiring the claimant to prove notice, revised section 8-503 requires the claimant to prove that the purchaser is “act[ing] in collusion with the securities intermediary in violating the securities intermediary’s obligations under Section 8-504.”<sup>225</sup> Professor Rogers argues that too much attention has been focused on this change, calling it at one point a “very small point of drafting technique”<sup>226</sup> that, no matter how it is expressed, will have no “material impact on the inevitable risk of intermediary theft.”<sup>227</sup> Even if this Author were to agree with Professor Rogers that the risk of theft occurring would not be increased,<sup>228</sup> the separate issue of whether the likelihood of any claimant’s recovery from a purchaser is lowered by the proposed collusion standard would remain. Finally, Professor Rogers argues that there is, in application, no difference between the new collusion standard and the old notice of adverse claims standard.<sup>229</sup>

## 2. New “Collusion” Standard

The *Article 8 Bar Report* relies on this last argument and spends a little more than three pages describing the new collusion standard as simply a restatement of New York case law. The Report has to engage in this process because there is no definition of “collusion” in Revised Article 8, although two Official comments do discuss collusion.<sup>230</sup> These three pages constitute an attempt to provide guidance

225. 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(e). Of course, the quoted language contains two separate elements. First, there must be “collusion.” Second, there must be a particular type of collusion: collusion to violate revised section 8-504, which provides that a securities intermediary must “promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all securities entitlements it has established in favor of its entitlement holders with respect to that financial asset.” *Id.* § 8-504(a). The import of this second requirement is not clear. Presumably it means that, for example, if Lender knows that Broker has a shortfall of security X but no shortfall of security Y, that Lender may purchase security Y free of any adverse claims. In other words, the Lender’s knowledge of bad action by Broker with respect to certain financial assets does not constitute collusion with respect to other financial assets. This interpretation would create yet another difficult barrier for any claimant to clamber over.

226. Rogers, *supra* note 7, at 1530 n.145.

227. *Id.* at 1530.

228. This Article argues at *infra* Part VI.A. that one of the reasons to withhold favored purchaser status from secured lenders who are in control is to encourage them to monitor their securities intermediary borrowers.

229. *Id.* at 1536.

230. The closest that Revised Article 8 comes to a definition are two Official Comments. The first is a description in the Official Comments of the fundamental principles behind revised section 8-503(e): “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 interest, *except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing.*” 1994 OFFICIAL TEXT, *supra* note 2, § 8-503 cmt. 2 (emphasis added).

The second describes the collusion test as applied to “a securities intermediary or a broker or other agent or bailee” as asking whether the participant conduct “rises to a level of

*complicity* in the wrongdoing” carried out by the customer or principal. 1994 OFFICIAL TEXT, *supra* note 2, § 8-115 cmt. 5 (emphasis added). The comment goes on to state that “[t]he collusion test is 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.” *Id.* (citing RESTATEMENT (SECOND) OF TORTS § 876). The *Restatement* standard requires, for liability, that the alleged aide and abettor (i) “act in concert with . . . [an]other or pursuant to a *common design* with him” or (ii) give “*substantial* assistance or encouragement” to another’s conduct that the alleged aide and abettor “knows” is “a breach of duty.” RESTATEMENT (SECOND) OF TORTS § 876 (1979) (emphasis added). There is a third category in the *Restatement*, but it requires an independent breach of a duty to the injured party by the alleged aider and abettor, something that is very unlikely in securities clearance and settlement, especially in the indirect holding system. *See id.*

Professor Rogers also draws attention to two sections of Article 9 where collusion is used either in the text of the UCC or the comments, stating that case law under these sections can give “guidance on the interpretation of the concept of collusion.” HAWKLAND & ROGERS, *supra* note 31, at 627. However, the case law under the sections mentioned by Professor Rogers does not clarify or help to define the concept of collusion. Both sections protect purchasers of collateral. Under either section, the courts, in denying protection to a purchaser, can rely solely on a failure of the purchaser to act in a commercially reasonable manner. Because of this two-tiered approach in which the courts look first to the commercial reasonableness of the actions undertaken before looking at collusion, the courts have never had occasion to define collusion. If one acts in collusion, he/she also will have acted in a commercially unreasonable manner. For this reason, the concept of collusion has not been adequately defined, even in the case law, which Professor Rogers points to as providing guidance on the meaning of collusion.

Section 9-504(4) protects a purchaser at public foreclosure sales, even if the sale did not meet Article 9 requirements, so long as the “purchaser has no knowledge of any defects in the sale and if he does not buy in *collusion* with the secured party, other bidders or the person conducting the sale.” U.C.C. § 9-504(4)(a) (1996) (emphasis added). Even though it is not specifically mentioned in either section 9-504(4) or the Official Comments to section 9-504(4), the courts applying section 9-504(4) rely on the concept of commercial reasonableness in determining whether a purchaser has “knowledge of any defects.” *See, e.g.,* Thornton v. Citibank, 640 N.Y.S.2d 110, 111 (N.Y. App. Div. 1996); PWS, Inc. v. Ban, 285 Cal. Rptr. 598, 601 (Cal. Ct. App. 1991); Sheffield Progressive, Inc. v. Kingston Tool Co., 405 N.E.2d 985, 988 (Mass. App. Ct. 1980).

The other provision that Professor Rogers points to for a definition of collusion is section 9-306. Section 9-306 provides that a secured party’s interest continues in “identifiable proceeds” from the sale of collateral and that a secured party is entitled to the proceeds from the sale of such collateral. U.C.C. § 9-306(2) (1996). Those proceeds are not identifiable if they are commingled with the funds of the debtor by being deposited in the debtor’s personal accounts. *See* Harley-Davidson Motor Co. v. Bank of New England, 897 F.2d 611, 620 (1st Cir. 1990).

Comment 2(c) to section 9-306 states that a transferee takes free of all claims by secured parties when funds are placed into a debtor’s checking account and paid out in “the ordinary course of business,” but that, in certain cases, recovery is warranted “by a secured party from a transferee out of the *ordinary course* or otherwise in *collusion* with the debtor to defraud the secured party.” U.C.C. § 9-306 cmt. 2(c) (1996) (emphasis added). In interpreting the phrase “ordinary course,” the courts look at whether a recipient of proceeds from the sale of collateral has failed to observe commercially reasonable standards or colluded in order to determine if the recipient is vulnerable to the claims of a secured party.

Unlike the situation under section 9-504(4), where there is no explicit reference to concepts of commercial reasonableness or the ordinary course of business, section 9-306, comment 2(c) explicitly mentions this two-tiered analysis. But the courts have never been required to adequately define collusion under section 9-306 because they have consistently relied solely on the concept of commercial reasonableness. *See, e.g.,* J.I. Case Credit Corp. v. First Nat’l Bank, 991 F.2d 1272, 1277 (7th Cir. 1993); *Harley-Davidson Motor Co.*, 897 F.2d at 622.

on the meaning of “collusion.”<sup>231</sup> Although the *Article 8 Bar Report* acknowledges that New York cases exist that would support the position “that overt proof of malicious interaction among conspirators must be demonstrated for collusion to be shown, or that collusion is a narrower category than is bad faith (as that term is used in New York Article 8),”<sup>232</sup> the report advocates what it presents as a lesser standard for establishing collusion.<sup>233</sup>

This section of the *Article 8 Bar Report* has an Alice-in-Wonderland quality. When interpreting New York statutes, New York courts ordinarily do not emphasize reliance upon legislative history.<sup>234</sup> This is not surprising when one remembers the paucity of New York legislative materials and the difficulty of public access to those few materials that do exist.<sup>235</sup> It is unlikely that any New York court, faced with the difference of language between revised sections 8-502 and 8-510 (notice) and section 8-503 (collusion), will be aware of the interpretation proposed by the *Article 8 Bar Report*. The New York court would have to wrestle with the differences in the new statutory language to arrive at its own conclusion. It seems unlikely to this Author that, even if a New York court were aware of the interpretation contained in the *Article 8 Bar Report*, the court would give it any more weight than any other secondary source. Indeed, New York courts are no less likely than those in other jurisdictions to interpret statutory provisions by looking at the explicit text and by treating different words in the same statute as having different meanings.<sup>236</sup>

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231. See ARTICLE 8 BAR REPORT, *supra* note 6, at 1 n.2 (“The Committee on Consumer Affairs has concluded that the Report . . . provides guidance regarding the operation of Sections 8-503 through 8-508, particularly with respect to the collusion standard and the meaning of good faith, which should diminish potential difficulties for individual investors . . .”).

232. *Id.* at 45 (discussing *Estate of Greene v. Glucksman*, 669 F. Supp. 63 (S.D.N.Y. 1987)).

233. See *id.* at 44. (“At a minimum, a demonstration that (i) the transferee had knowledge that the intermediary was acting wrongfully with respect to the financial assets transferred and (ii) the transferee acted in concert with the intermediary in doing so, will be sufficient to meet the collusion standard.”) Exactly how this proposed standard, with its “in concert” language, differs from the higher standard that the *Article 8 Bar Report* claims is inappropriate is not at all clear to this Author. See *id.* In addition, the *Article 8 Bar Report* provides an interpretation of how to resolve the procedural issues of proof under a collusion standard: “Under Revised Article 8, once an entitlement holder comes forward with some colorable evidence of collusion, the burden of going forward to show the absence of collusion should be placed on the transferee.” *Id.*

234. See 97 N.Y. JUR. 2d *Statutes* §§ 145-46 (1992).

235. See ELLEN M. GIBSON, *NEW YORK LEGAL RESEARCH GUIDE I-92* (2d ed. 1998); see also ROBERT A. CARTER, *LEGISLATIVE INTENT IN NEW YORK STATE: MATERIALS, CASES AND ANNOTATED BIBLIOGRAPHY 2* (1981); Ernest H. Breuer, *Legislative Intent and Extrinsic Aids to Statutory Interpretation in New York*, 51 L. LIBR. J. 2, 3 (1958).

236. See *Albano v. Kirby*, 330 N.E.2d 615, 618 (N.Y. 1975) (“When different terms are used in various parts of a statute or rule, it is reasonable to assume that a distinction between them is intended.”) (citations omitted).

Although Official Comments are not part of the UCC, courts, including New York courts, often look to them for guidance.<sup>237</sup> A New York court, relying on the two comments in Revised Article 8, easily could construe “collusion” to cover only a narrow range of conspiratorial conduct,<sup>238</sup> the very concept rejected by the *Article 8 Bar Report*.

The bill adopting Revised Article 8 in New York has a statement of legislative intent in a preamble that clarifies that the collusion standard is the narrow concept suggested by the literal language of Revised Article 8.<sup>239</sup> The bill states that “[t]he legislature intends collusion to include acting in concert, acting by conspiratorial arrangement, or acting by agreement for the purpose of violating the entitlement holder’s rights or with actual knowledge that the securities intermediary is violating those rights.”<sup>240</sup> The 1996 predecessor bill passed by the Assembly had a much different clarification of collusion. The 1996 bill provided that, beyond the normal meanings of collusion, “[t]he legislature also intends collusion to include actual knowledge by a party or a party’s deliberate closing of its eyes to facts that would provide knowledge.”<sup>241</sup> Although a helpful step, this

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237. See, e.g., 107 N.Y. JUR. 2d *Uniform Commercial Code* §§ 3, 19 (1992).

238. If a New York court were to look at comment 5 to revised section 8-115, it would find that “[k]nowledge that the action of the customer is wrongful is a necessary but not sufficient condition of the collusion test.” 1994 OFFICIAL TEXT, *supra* note 2, § 8-115 cmt. 5. To find that there has been collusion, the comment advocates that a securities intermediary or broker must engage in “affirmative misconduct in assisting the customer in the commission of a wrong.” *Id.*

239. See *Uniform Commercial Code-Investment Securities*, 1997 N.Y. LAWS 566, at § 1.

240. *Id.* The language from the legislative intent preamble, startling in its bluntness, goes on to state the following:

Under this standard, “collusion” includes transactions with a securities intermediary in which the purchaser has actual knowledge that the securities intermediary has violated or is violating an entitlement holder’s property interest. The legislature intends that the purchaser’s knowledge will be judged on a subjective, not an objective basis. When considering whether a purchaser has the requisite actual knowledge of the wrongdoing, the legislature intends that the purchaser be charged with possession of information that is brought to the purchaser’s attention or that is contained in communications made or sent to the purchaser but that the purchaser has declined to receive or to communicate to persons within its own organization who are conducting the transaction. Nevertheless, nothing in this standard imposes a duty of inquiry. Thus, for example, a purchaser’s knowledge of the precarious financial situation of the financial intermediary coupled with rumors, allegations, or reports of suspected wrongdoing does not amount to collusion. As used in this act, the collusion standard strikes a balance between two competing goals—the need for liquidity and finality in the market for financial assets and the need for assurance that the rules that protect liquidity and finality are not subject to abuse by a purchaser who is willing to participate with or assist an intermediary for the purpose of violating the rights of an intermediary’s customers, or a purchaser who acts with actual knowledge of an intermediary’s wrongdoing.

*Id.* The last sentence of the above paragraph talks about balancing two “competing goals.” This Author fails to see anything but a tipped scale.

241. A. 9454-B § 1 (N.Y. 1996). “[C]arelessness” or “negligence” would not have been enough. The bill gave an example of carelessness or negligent behavior that “does not

approach still read any requirement of good faith out of New York law. In addition, one can only speculate about what New York courts would have done with a legislative statement of intent that conflicts with the explicit language of the statute and the Official Comments. Now one does not have to speculate. The triumph of the financial institutions is complete and not even the few crumbs offered by the *Article 8 Bar Report* are left for investors.

### B. Securities Intermediaries

Revised section 8-503(a) is one of the more radical sections of Revised Article 8. It establishes the general principle that financial assets held by a securities intermediary are held by the securities intermediary for its entitlement holders to the extent necessary to satisfy the entitlement holders and “are not property of the securities intermediary.”<sup>242</sup> As Professor Rogers notes, “if an intermediary acquires securities for its own account, and thereafter customers acquire claims to that issue of securities, all units of that security will be devoted first to the customers’ claims.”<sup>243</sup> Revised section 8-511(a) carries out this general principle by providing that if a securities intermediary were to have a shortfall in a particular financial asset, all claims of entitlement holders who have interests in the financial asset would have priority over any claim of a creditor of the securities intermediary.<sup>244</sup> It is especially important that such a policy choice favoring entitlement holders has been made as most investors rarely will be able to assert a claim against any particular financial asset due to their inability to trace the financial asset.<sup>245</sup>

Professor Rogers concludes that revised sections 8-503(a) and 8-511 embody the basic principle that “entitlement holders of an intermediary do not take the credit risk of the intermediary.”<sup>246</sup> He can conclude that this basic principle has been properly embodied in Revised Article 8 only by focusing on the claims of general creditors against securities intermediaries. Once the focus shifts to certain types of secured lenders, it becomes clear that entitlement holders may well be taking a credit risk with their securities intermediaries.

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amount to collusion.” “a purchaser’s knowledge only of the precarious financial situation of the financial intermediary coupled with rumors or unsupported reports.” *Id.* In other words, good faith no longer would have been an independent requirement under New York law.

242. 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(a).

243. Rogers, *supra* note 7, at 1518.

244. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-511(a).

245. See *supra* text accompanying notes 223-25.

246. Rogers, *supra* note 7, at 1518.



### 1. *Control Creditors*

By defining a securities entitlement as a bundle of rights against a securities intermediary rather than as a right in any financial asset, Revised Article 8 would have the effect of increasing entitlement holders' exposure to the risk of insolvency of their securities intermediaries. This insolvency risk arises from the crucial exception that revised section 8-511 makes in favor of entitlement holders: Any claim of a creditor of the securities intermediary that has *control* of the financial asset has priority over any claim of an entitlement holder to the financial asset.<sup>247</sup> A purchaser, including any control creditor,<sup>248</sup> would control a financial entitlement when either (a) the purchaser were to "become[ ] the entitlement holder"<sup>249</sup> or (b) the securities intermediary that creates the securities entitlement were to "agree[ ] that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder."<sup>250</sup> Control creditors would include not only certain secured lenders but also certain higher level securities intermediaries that create securities entitlements for lower level securities intermediaries.<sup>251</sup>

The insolvency risk arises from the very nature of secured lending. If the financial assets and other assets that a securities intermediary holds for its own account have been pledged to a secured lender and the secured lender has control of these financial assets, the only financial assets left to satisfy claims of entitlement holders will be those held by the securities intermediary on behalf of its entitlement holders.<sup>252</sup> If the financial intermediary becomes insolvent and there is a shortfall in the financial assets held on behalf of entitlement holders, the entitlement holders will be only general creditors with

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247. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-511(b).

248. A "purchaser" is "a person who takes by purchase." U.C.C. § 1-201(33) (1996). In turn, a "purchase" is "any . . . voluntary transaction creating an interest in property, *id.* § 1-201(32), which includes security interests granted to lenders.

249. 1994 OFFICIAL TEXT, *supra* note 2, § 8-106(d)(1).

250. *Id.* § 8-106(d)(2).

251. See *id.* § 8-106(e). The lower level securities intermediary, in its capacity as an entitlement holder, must grant "an interest" in the security entitlement to the higher level securities intermediaries for control to exist. *Id.* Priorities among control creditors are dealt with in revised section 9-115(5). See generally *Super-Priority of Securities Intermediaries under the New Section 9-118(5)(c) of the Uniform Commercial Code*, 108 HARV. L. REV. 1937 (1995) (discussing arguments on priority issue available to a secured creditor and a securities intermediary when both are in control).

252. The lack of empirical data concerning lending to broker-dealers makes it difficult to evaluate the likelihood of this scenario. Is it common for a broker-dealer to have a senior lender that has a security interest in substantially all of its assets? Does the answer to this question vary depending on what type of broker-dealer is involved, e.g., large publicly held versus small privately held? Moreover, even if control lending has been uncommon in the past, will revised section 8-511(a) provide an incentive to increased control lending in the future? See *infra* text accompanying notes 260-65 for a brief discussion of borrowing by broker-dealers.

respect to the shortfall and may well suffer a loss. Assume Securities Intermediary holds fifty A shares for its own account and fifty A shares on behalf of Entitlement Holder. Assume Securities Intermediary has granted control to a Secured Lender over the fifty A shares held for its own account. Assume finally that Securities Intermediary misappropriates twenty-five customer A shares and grants control to the Secured Lender, which is noncolluding, over these twenty-five A shares. If Securities Intermediary becomes insolvent, Entitlement Holder has priority under revised section 8-511 only with respect to the twenty-five customer A shares that were not misappropriated by Securities Intermediary. A related scenario shows that an entitlement holder can even be subjected to unbargained for market risks involving financial assets in which the entitlement holder did not invest.

Assume Securities Intermediary grants control to Secured Lender of 100 A shares with a market value of \$50 per share and fifty B shares with a market value of \$100 per share in return for a loan of \$10,000. Assume further that Securities Intermediary has violated the Entitlement Holder's rights in granting control over the fifty B shares but that Secured Lender has not colluded in this violation. Assume finally that, upon Securities Intermediary's default on the loan, the A shares have a market value of zero dollars. Now Secured Lender has priority over Entitlement Holder with respect to all of the B shares. Thus, Entitlement Holder has become subject to the market risk of a decline in the value of A shares, in which he or she may not have invested, if Securities Intermediary wrongfully grants control to Secured Lender over the fifty B shares and Securities Intermediary becomes insolvent.

The same risks, of course, would arise under 1977 Article 8 if Secured Lender were a bona fide purchaser of the twenty-five A shares under the first hypothetical or fifty B shares under the second hypothetical.<sup>253</sup> But, to date, little bona fide purchaser secured lending has been done under Article 8.<sup>254</sup>

If one confines consideration of this issue purely to the language of 1977 Article 8 and ignores the approach taken by the courts in applying 1977 Article 8, Revised Article 8 arguably decreases, not increases, an entitlement holder's exposure to insolvency risk. Under 1977 Article 8, most indirectly held securities are held as part of a "fungible bulk," in which "the purchaser is the owner of a proportionate property interest;"<sup>255</sup> therefore, tracing and earlier-in-time con-

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253. See 1977 OFFICIAL TEXT, *supra* note 4, §§ 8-313(1)(g), (2), 8-320.

254. See Howard M. Darmstadter, *Revised Article 8 and the Agreement to Pledge*, 28 UCC L.J. 202, 211-12 (1995).

255. 1977 OFFICIAL TEXT, *supra* note 4, § 8-313(2). Exceptions for indirectly held securities exist for a "certificated security specially [e]ndorsed to or issued in the name of the

cepts, which in theory operate fortuitously, should determine whether customers or creditors receive priority.<sup>256</sup> What this argument ignores is that

in almost all cases [involving government broker-dealers, the courts] tried to find ways of favoring customers seeking to assert ownership rights in securities held by broker-dealers over creditors claiming security interests in the same. . . . After reading these cases, it should be obvious why the securities clearing industry is so anxious to 'reform' existing law, and why retail customers might be a little less eager.<sup>257</sup>

These exercises in judicial creativity have involved the use of "fictions of vicarious possession."<sup>258</sup> Difficult as such exercises were to justify under 1977 Article 8, such exercises would be almost impossible to justify under Revised Article 8 with its explicit rejection of any tracing notions with respect to financial assets.

As a practical matter, these changes in Revised Article 8 would not be a significant concern if control lending were not a significant securities industry practice or if creditors were subject to meaningful restrictions on their ability to become favored purchasers. There is very little empirical research on broker-dealers borrowing. In addition, this Author is unaware of any authoritative study of securities lending practices that addresses the more narrow issue of the extent to which control-type relationships are currently common industry practice. Anecdotal evidence indicates that control-type lending relationships are not currently important to major broker-dealers in their normal operations, although they may be important to smaller broker-dealers.<sup>259</sup>

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purchaser" in the "possession" of a financial intermediary, *id.* § 8-313(1)(c), and "a specific certificated security in the financial intermediary's possession" that the financial intermediary has "identify[d] as belonging to the purchaser," *id.* § 8-313(1)(d)(i).

256. See 1991 ABA REPORT, *supra* note 5, at 36-37. See James S. Rogers, *UCC Article 8-Investment Securities: The Need for Revision to Accommodate Securities Holdings through Financial Intermediaries*, in 1993 COMM. L. ANN. 419 (Louis F. Del Duca & Patrick Del Duca eds., 1993), for a variety of hypotheticals involving transfers under 1977 Article 8.

257. Schroeder, *supra* note 31, at 335-36. One supporter of Revised Article 8 has written that

Honesty compels me to say that in the event of . . . [a reduction or disappearance of] federal regulation, current Article 8 might be marginally preferable to Revised Article 8. In the event of that regulatory revolution, what are flaws in current Article 8 become virtues. Under current Article 8, it is possible to make property-based arguments that would allow original owners to claim their lost property back from transferees.

Letter from Paul M. Shupack to Norman Silber, Professor, Hofstra School of Law, 12 (June 13, 1995) (on file with author) [hereinafter Shupack Letter].

258. Schroeder, *supra* note 31, at 336.

259. See Darmstadter, *supra* note 254, at 211-12 (reporting that brokers with publicly held parents primarily borrow unsecured in public debt markets and that, when borrowing is necessary, secured bank loans are available to "large, credit-worthy" brokers at the same

Professor Rogers devotes three pages to a description of broker-dealer borrowing, citing to only a handful of sources.<sup>260</sup> Professor Mooney proposed the model of “upper-tier priority,”<sup>261</sup> which became the intellectual foundation of Revised Article 8, without once examining actual borrowing practices of broker-dealers.<sup>262</sup> Broker-dealers have diversified away from a reliance on banks, using repurchase agreements with a variety of counter parties for their day-to-day liquidity needs.<sup>263</sup> Committed bank lines of credit, however, remain the fall back for broker-dealers in times of great liquidity needs.<sup>264</sup>

Primary dealers in Treasury securities presently rely on repurchase agreements to finance most of their positions rather than on collateralized loans from commercial banks, which were utilized in the past.<sup>265</sup> This movement to repos as the primary financing device is also true of broker-dealers in general.<sup>266</sup> There are three common types of repurchase agreements: delivery, tri-party and custody. In a delivery repo, the purchaser takes possession of the underlying securities, which is the repurchase market’s version of the hard pledge discussed below. In a tri-party repo, a third party, such as a bank, acts on behalf of the purchaser and seller and “holds the repo collateral put up by the dealer in custody for the investor for the life of the repo.”<sup>267</sup> Finally, in custody repos, the underlying securities remain with the seller.<sup>268</sup> Custody repos remain popular with investors due

interest rates as secured loans). Standby secured lending facilities for providing liquidity to a broker-dealer holding company would be important in the event that its access to the commercial paper market were to dry up. See OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS 116 (1990).

260. See Rogers, *supra* note 7, at 1527-29 (citing to two sources).

261. Professor Mooney describes this model:

The cornerstone of the priority rule proposed here is one overriding principle: claimants on a higher tier will *always* prevail over claimants on a lower tier. To state this principle of *upper-tier priority* . . . another way, the transferee of an interest in a fungible bulk of securities controlled by its intermediary can look *only* to its intermediary for the benefits of the securities transferred.

Mooney, *supra* note 114, at 379-80.

262. *Id.* at 379-97.

263. After the October 1987 stock market crash and problems obtaining bank loans, broker-dealers sought to increase their sources of credit by increasing their use of the repurchase market. See Stephen E. Frank, *The Carnage in Stocks: If the Sell-Off Continues, Banks Have Crucial Role*, WALL ST. J., Oct. 28, 1997, at C19.

264. See *id.* Broker-dealers pay a “small annual premium” for these lines of credit, which can be quite substantial in size. See *id.* Merrill Lynch & Co., for example, has \$6.6 billion available through its committed credit lines. See *id.* Most of these lines are unsecured, although some banks are now asking for collateral. See *id.*

265. See UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-86-80 BR, U.S. TREASURY SECURITIES: THE MARKET’S STRUCTURE, RISKS, AND REGULATION 24-25 (1986) [hereinafter GAO, TREASURY SECURITIES].

266. SEC, THE FINANCING AND REGULATORY CAPITAL NEEDS OF THE SECURITIES INDUSTRY 22-23 (1985). Repurchase agreements are cheaper than bank loans and allow for borrowing against a larger percentage of the collateral pool. See *id.* at 23.

267. STIGUM, REPO, *supra* note 101, at 191-201.

268. See *id.*

to the lower costs associated with them,<sup>269</sup> and with broker-dealers because of operational efficiencies that accompany custody repos.<sup>270</sup>

Professor Rogers assumes that, as a significant amount of control lending is done by mutual funds and pension funds, any rule favoring entitlement holders over controlling secured creditors would only end up hurting individuals with interests in mutual funds and pensions.<sup>271</sup> Without some real data on lending to broker-dealers it is impossible to evaluate this point. The most favorable public policy may change depending on the percentage of the borrowing that the typical broker-dealer finances with money market mutual funds and pension funds. The higher the percentage, the more attractive Professor Rogers' argument becomes. But even if the percentage is very high during normal business times, will the same lenders be there during crises in either the financial markets as a whole or in the business of one particular broker-dealer? Major broker-dealers have not made this assumption, relying on committed bank lines of credit for crisis periods.<sup>272</sup>

In addition, the evidence of past bank lending practices, in which agreement to pledge arrangements have been favored, may not be an accurate guide for future bank lending practices. Banking lawyers are now advising their clients that control arrangements are the preferred method of perfecting security interests in securities under Revised Article 8.<sup>273</sup> Agreement-to-pledge arrangements are, in Revised Article 8's terms, non-control arrangements.<sup>274</sup> One goal of Revised Article 8 was to provide an unambiguous legal foundation for agreement to pledge lending.<sup>275</sup> But the primary impetus behind agree-

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269. See *id.* at 199-200; see also GAO, TREASURY SECURITIES, *supra* note 265, at 106-07, 113.

270. See STIGUM, REPO, *supra* note 101, at 198-99.

271. See Rogers, *supra* note 7, at 1523-29. Professor Rogers explains this point:

If one really does think that sound public policy dictates that providers of financing to securities firms should lose to customers of the firm in the event that the firm has wrongfully transferred securities, then one has to bite the bullet and say that one thinks it sensible to shift the risk of loss from the customers of a failed securities firm to shareholders of a money market mutual fund.

*Id.* at 1528.

272. See Frank, *supra* note 263, at C19. But see Tom Pratt, *Will Your Bank Be There When You Need It Most? Secured Credit Lines Appeal to Brokerage Firms for Crisis Protection*, INVESTMENT DEALERS' DIG., Feb. 28, 1994, at 10 (reporting that, as of early 1994, only two major broker-dealers had setup committed secured bank lines, although other firms were considering such bank lines).

273. See, e.g., Alan M. Christenfeld & Shephard W. Melzer, *Treasury Securities: New Federal Regulations*, N.Y. L.J., June 5, 1997, at 5 ("Most secured parties will find that 'control' is the most useful means to perfect liens on treasuries," which are now subject to Revised Article 8 by Department of the Treasury rules.)

274. See 1994 OFFICIAL TEXT, *supra* note 2, § 9-115 cmt. 6.

275. See Darmstadter, *supra* note 254, at 206-07. New York accomplished this through amendments in 1988 to section 8-313 of 1977 New York Article 8. See Act to Amend the Uniform Code, in Relation to Clarifying the Definition of Financial Intermediary and the

ment to pledge lending may have been technological deficiencies in depository operational handling of pledges—deficiencies that may soon be overcome.<sup>276</sup> In the event that the deficiencies are overcome, control lending could become increasingly important.<sup>277</sup> In addition, the new rule set forth in revised section 8-511(a) favoring entitlement holders over non-control creditors should provide a significant incentive to bank lenders to create control lending arrangements. If control bank lending grows in importance, the net result of revised section 8-511(b) would put entitlement holders at a severe disadvantage in future insolvencies of securities intermediaries involving a shortfall of financial assets and significant bank creditors.

Revised section 8-511(b) raises two issues related to a creditor's ability to become a favored purchaser. First, the meaning of "control" of a security entitlement in Revised Article 8 is unclear and the current draft of proposed Article 9 proposes a clarification that will remove any ambiguities in achieving "control" over a security entitlement by giving a very broad meaning to "control." The first means of obtaining control under revised section 8-106(d), "the purchaser becomes the entitlement holder,"<sup>278</sup> has not generated discussion. The second means, "the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder,"<sup>279</sup> has prompted all of the debate. The issue is whether an agreement by a securities intermediary to follow entitlement orders of a "purchaser"<sup>280</sup> that is conditioned upon the occurrence of some further event, such as a default by the

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Transfer of Interests in the Securities that Remain in the Possession of a Financial Intermediary, ch. 708, 1988 N.Y. LAWS 1452.

276. See Darmstadter, *supra* note 254, at 213-15.

277. Cost should not be a significant deterrent. One 1995 article reported that Depository Trust Company, for example, charged only eleven cents per CUSIP number, i.e., per securities issue, for a "hard pledge." See *id.* at 213. A "hard pledge" occurs when "securities are transferred on the books of a clearing corporation from the debtor's account to the lender's account or to a special pledge account for the lender where they cannot be disposed of without the specific consent of the lender." 1994 OFFICIAL TEXT, *supra* note 2, § 9-115 cmt. 6.

278. *Id.* § 8-106(d)(1).

279. *Id.* § 8-106(d)(2).

280. Although the most common transaction involving a purchaser might be a secured transaction, revised section 8-106 uses the more general term "purchaser" in order to cover repurchase agreements, which have been characterized by some courts as purchase-and-sale arrangements and by other courts as secured transactions. See HAWKLAND & ROGERS, *supra* note 31, at 232 ("By using the term purchaser, it is possible to state rules for repurchase agreement transactions in a fashion that makes it unnecessary . . . to decide the disputable question of whether . . . the transfer of securities in a repo transaction is . . . governed by Article 9."). This word usage allows Revised Article 8 to remain neutral on the issue of the legal characterization of repurchase agreements. See *Prefatory Note*, 1994 OFFICIAL TEXT, *supra* note 2, at 23-24. ("The rules of Revised Article 8 have . . . been drafted to minimize the possibility that disputes over the characterization of the transfer in a repo would affect substantive questions that are governed by Article 8.")

entitlement holder that has granted a security interest, can constitute a “control” arrangement.

In part, this debate has been occasioned by Official Comment 7 to revised section 8-106, which applies a general gloss on the meaning of “control.” “The key to the control concept is that the purchaser has the *present* ability to have the securities sold or transferred without further action by the transferor.”<sup>281</sup> The use of “present” suggests that any future condition means control does not exist currently because an entitlement order will not be followed until the condition occurs.<sup>282</sup>

The latest draft of Article 9 suggests a change to Official Comment 7 to revised section 8-106 to delete the word “present” in the first sentence of the last paragraph and to add four new sentences clarifying that “a purchaser may have present control of a security entitlement even though the purchaser’s right to give entitlement orders to the securities intermediary is conditioned on the entitlement holder’s default or the purchaser’s informing the securities intermediary that the entitlement holder is in default.”<sup>283</sup> This change would

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281. 1994 OFFICIAL TEXT, *supra* note 2, § 8-106 cmt. 7 (emphasis added).

282. Some attorneys will not render “control” opinions in this factual situation because of this language in the Official Comments. See Kenneth C. Kettering, *Rev. Art. 8 and Multiple Secured Parties* (visited Apr. 23, 1997) <<http://ucclaw-l@assocdir.wuacc.edu>>. The practical solution has been to put any conditions in a separate document to which the securities intermediary is not a party. See Steve Weise, *Rev. Art. 8 and Multiple Secured Parties* (visited Apr. 24, 1997) <<http://ucclaw-l@assocdir.wuacc.edu>>.

A separate, but related issue, is raised by the requirement that the securities intermediary agree to act “without further consent by the entitlement holder” for control of a security entitlement to exist. 1994 OFFICIAL TEXT, *supra* note 2, § 8-106(d)(2). This language also suggests the practical wisdom of keeping any conditions on the exercise by a secured party of its rights in a separate document between the secured party and the debtor. As Professor Rogers notes:

Lawyers negotiating and drafting [control] agreements should take care to keep separate the question whether the arrangement suffices to give the secured party the power to obtain the collateral from the intermediary and the question whether the secured party’s exercise of that power in a particular situation is rightful as against the debtor.

HAWKLAND & ROGERS, *supra* note 31, at 235.

283. Uniform Commercial Code Revised Article 9 Secured Transactions; Sale of Accounts, Chattel Paper, And Payment Intangibles; Consignments (with conforming amendments to Articles 1, 2, 5, and 8) app. § 8-106 cmt. 7 (Discussion Draft No. 2, April 14, 1997). The full text of these four proposed new sentences is as follows:

Moreover, the purchaser’s right to direct the intermediary may be subject to conditions. For example, a purchaser may have present control of a security entitlement even though the purchaser’s right to give entitlement orders to the securities intermediary is conditioned on the entitlement holder’s default or the purchaser’s informing the securities intermediary that the entitlement holder is in default. Better practice for both the intermediary and the purchaser would be to insist that any conditions be effective only as between the purchaser and the entitlement holder. That would avoid the risk that the intermediary could be caught between conflicting assertions of the entitlement holder and the purchaser as to whether the conditions in fact have been met. Nonetheless, the ex-

protect both secured parties and purchasers in repurchase agreements to the extent such purchasers are treated as secured parties.

Delivery repos should create control in the purchaser, regardless of whether the underlying financial assets are certificated securities, uncertificated securities or security entitlements. The proposed revised Official Comment would clarify that tri-party and custody repos may create control relationships even if there are conditions to a purchaser's exercise of its rights. If all repurchase agreements, including custody repos, can involve a "control" arrangement, then one potential conceptual barrier to "control" lending's domination of securities intermediaries financing has been removed.

In addition, the limits on a control creditor are unclear. In other words, is revised section 8-511(b) subject to the collusion standard of revised section 8-503(e)? The Official Comments to revised section 8-511(b) state that such a connection exists<sup>284</sup> but nothing in the text of the statute explicitly subjects a control creditor to revised section 8-503(e).<sup>285</sup> As discussed above, even if the collusion test applies to control creditors, it fails to provide meaningful protection for entitlement holders.<sup>286</sup>

## 2. *Impact of the Multi-Tier System*

The potential problems with control lending are magnified by the fact that the indirect holding system is a multi-tier system. If there were to be (a) a shortfall in a financial asset at a higher level securities intermediary that has a control creditor with respect to the financial asset and on whose books a lower level securities intermediary has a securities entitlement with respect to the financial asset on

istence of unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control.

*Id.*

284. 1994 OFFICIAL TEXT, *supra* note 2, § 8-511 cmt. 1 ("If . . . the secured creditor acted in collusion with the intermediary in violating the intermediary's obligation to its entitlement holders, then under section 8-503(e), the entitlement holders . . . could recover the interest from the secured creditor . . .").

285. What weight, if any, to be given the Official Comments in interpreting the UCC has been a matter of some controversy. Compare Laurens Walker, *Writings on the Margin of American Law: Committee Notes, Comments, and Commentary*, 29 GA. L. REV. 993, 994 (1995) ("[C]ourts should assign little, if any, weight to these examples of gloss [such as U.C.C. comments] . . . [T]hese materials are not a desirable addition to American jurisprudence.") with Julian B. McDonnell, *Purposive Interpretation of the Uniform Commercial Code: Some Implications for Jurisprudence*, 126 U. PA. L. REV. 795, 806 (1978) (advocating a purposive interpretation of the UCC that has, as one of its steps, an examination of the purpose articulated in the Official Comments); Robert H. Skilton, *Some Comments on the Comments to the Uniform Commercial Code*, 1966 WIS. L. REV. 597, 631 ("Study of the comments is indispensable to a knowledge of the Code."); Sean Hannaway, Note, *The Jurisprudence and Judicial Treatment of the Comments to the Uniform Commercial Code*, 75 CORNELL L. REV. 962, 985-86 (1990) ("The truth of the matter is that the Comments are authoritative.").

286. See *supra* text accompanying notes 231-42.



behalf of its own entitlement holder and (b) the higher level securities intermediary were to become insolvent, the entitlement holder might find him or herself with a shortfall of financial assets on which he or she has a claim.<sup>287</sup> The lower level securities intermediary does not necessarily have to replace these financial assets. Although revised section 8-504(a) provides that “[a] securities intermediary *shall* promptly *obtain* and thereafter *maintain* a financial asset in a quantity corresponding to the aggregate of all securities entitlements it has established in favor of its entitlement holders with respect to that financial asset,”<sup>288</sup> the lower level securities intermediary may, in turn, hold these financial assets indirectly.<sup>289</sup>

The duty set forth in revised section 8-504(a) is not absolute. If the lower level securities intermediary has “exercise[d] due care in accordance with reasonable commercial standards to obtain and maintain the financial asset,” it has met its duty to obtain and maintain the financial asset.<sup>290</sup> Thus, an insolvency of the higher level securities intermediary that could not reasonably be foreseen would appear to relieve the lower level securities intermediary of any duty to the entitlement holder for financial assets held through the higher level securities intermediary.<sup>291</sup>

Professor Mooney, the intellectual progenitor Revised Article 8’s general approach, proposed that a much more stringent “warranty of good title” be made by a securities intermediary in favor of its entitlement holders.<sup>292</sup> This “warranty” was to be the quid pro quo for subjecting entitlement holders to the risk of a policy favoring upper-

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287. The entitlement holder only has a property interest in particular financial assets, not in all financial assets held for customers. See 1994 OFFICIAL TEXT, *supra* note 2, §§ 8-503(a), (b).

288. 1994 OFFICIAL TEXT, *supra* note 2, § 8-504(a) (emphasis added). The Official Comments justify restricting an entitlement holder to recourse against his or her securities intermediary when the securities intermediary is solvent by giving an expansive reading to revised section 8-504: “If the intermediary does not hold financial assets corresponding to the entitlement holders’ claims, the intermediary has the duty to acquire them.” *Id.* § 8-503 cmt. 2. This would not necessarily be true in the event of an insolvency of a higher level securities intermediary. See *infra* text accompanying notes 300-06.

289. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-504(a) (“The securities intermediary may maintain those financial assets directly or through one or more other securities intermediaries.”).

290. *Id.* § 8-504(c)(2).

291. There also are potential procedural pitfalls for an entitlement holder if his or her securities intermediary became insolvent while there was a shortfall in a financial asset at a higher level securities intermediary. An “entitlement holder cannot assert rights [under Revised Article 8] directly against other persons [other than his or her own securities intermediary], such as other intermediaries through whom the intermediary holds the positions . . . except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing.” *Id.* § 8-503 cmt. 2. Any legal action against the higher level securities intermediary would have to be brought by the lower level securities intermediary as debtor-in-possession or by its trustee.

292. Mooney, *supra* note 114, at 405-10.

tier market participants.<sup>293</sup> Revised Article 8 has significantly diluted this suggested “warranty.”<sup>294</sup> This Author can imagine the justification for such dilution that could be made by supporters of Revised Article 8. By holding indirectly, entitlement holders have agreed to subject themselves to these risks.<sup>295</sup> This Author would have more sympathy for this argument, however, if there were any practical means of holding publicly traded securities other than indirectly.<sup>296</sup>

### 3. *Direct Intermediary Interests*

Finally, there are risks imposed on individual investors by the control relationship that may exist between a securities intermediary and its entitlement holders. Revised section 8-106(e) grants control of a securities entitlement held for an entitlement holder to a securities intermediary when the securities intermediary has an “interest” in the security entitlement. The language of revised section 8-106(e) is quite vague.<sup>297</sup> There is no definition of “interest.”<sup>298</sup> The only guidance is in the Official Comments to revised section 8-106, which state that “[a] common transaction covered by this provision is a margin loan from a broker to its customer.”<sup>299</sup> Revised Article 8 may be referring to a *security* interest in 8-106 (e). This would make sense if control were relevant only in Article 9 and in determining priority

293. *See id.* at 380.

294. Professor Rogers would not agree with this characterization. In describing revised section 8-504, he has written:

[T]he basic statement in subsection 8-504(a) of the intermediary’s duty to maintain assets corresponding to entitlement holders’ claims does not say that an intermediary shall “try to have the assets” or “take reasonable measures to try to have the assets”; it states flatly that the intermediary “shall promptly obtain and thereafter maintain a financial asset” corresponding to each security entitlement that it has established.

HAWKLAND & ROGERS, *supra* note 31, at 652.

This Author believes that a court can easily read revised sections 8-504(a) and (b) together to stand for exactly the proposition that Professor Rogers rejects.

295. Professor Mooney makes a similar argument with respect “to defects or defaults where the issuer is at fault,” noting that the warranty should not extend to such defects and faults “since the qualities of the issuer and the issuer’s behavior comprise risks properly assumed and borne by the transferee.” Mooney, *supra* note 114, at 405 n.363.

296. *See infra* Part VII for a discussion of the impracticality of opting out of the indirect holding system.

297. A securities intermediary has “control” “[i]f an interest in a security entitlement is granted by the entitlement holder to the entitlement holder’s own securities intermediary.” 1994 OFFICIAL TEXT, *supra* note 2, § 8-106(e).

298. Presumably an “interest” is a property right of some type created by a “purchase.” *See* U.C.C. § 1-201(32) (1996) (“Purchase” includes taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an *interest* in property.”) (emphasis added).

299. 1994 OFFICIAL TEXT, *supra* note 2, § 8-106 cmt. 6. The last paragraph of Comment 4 to revised section 9-115 also defines control by reference to a customer’s borrowing from its securities intermediary and granting the securities intermediary a security interest in connection with a borrowing. 1994 OFFICIAL TEXT, *supra* note 2, § 9-115 cmt. 4.

among conflicting security interests.<sup>300</sup> But control performs an additional, albeit a more limited, function in the indirect holding system in connection with adverse claim protection for transferees in general rather than just for holders of security interests.<sup>301</sup>

Through revised section 8-106(e), the individual investor is subject to risks involving not just control lenders to higher level securities intermediaries, but also to risks involving the higher level securities intermediary itself. Assume entitlement holder has a security entitlement with respect to a financial asset at a lower-level securities intermediary (LLSI), which financial asset in turn is held by LLSI in a security entitlement at a higher level securities intermediary (HLSI). Assume further that HLSI has a revised section 8-106(e) “interest” in LLSI’s security entitlement, that HLSI is a favored purchaser of LLSI’s security entitlement, that there is a shortfall in the financial asset at HLSI, and that HLSI becomes insolvent. The entitlement holder may well suffer a shortfall in the financial asset.

This statutory approach means that any individual entitlement holder is subject to risks of a shortfall of a financial asset not only at his or her securities intermediary but at all securities intermediaries in the chain from the entitlement holder to the depository for the financial asset. Of course, if the higher level securities intermediary were not to become insolvent, the lower level entitlement holder would be protected against a short fall at the higher level securities intermediary through revised sections 8-503(a) and 8-504, unless the shortfall at the higher level securities intermediary was due, in turn, to the insolvency of an even higher level securities intermediary.

### C. Secured Creditors of Clearing Corporations

Even if an entitlement holder did not lose in a priority contest with a control lender over a financial asset in which there was a shortfall, he or she could still lose to a creditor of a clearing corporation when the creditor “has a security interest in that financial asset.”<sup>302</sup> The creditor of a clearing corporation does *not* have to control

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300. Revised section 9-115(5) provides the priority rules for “conflicting security interests in the same investment property.” *Id.* § 9-115(5). A security interest of a secured party with control has priority over that of a secured party without control. *See id.* § 9-115(5)(a). In turn, revised section 9-115(5)(c) creates a default rule that gives “a security interest in a security entitlement . . . granted to the debtor’s own securities intermediary . . . priority over any security interest granted by the debtor to another secured party.” *Id.* § 9-115(5)(c). Revised section 9-115(5)(c) is an exception to the general rule of revised section 9-115(5)(b) that provides that “conflicting security interests of secured parties each of whom has control rank equally.” *Id.*

301. *See* HAWKLAND & ROGERS, *supra* note 31, at 224-25.

302. 1994 OFFICIAL TEXT, *supra* note 2, § 8-511(c). *See id.* § 9-115 cmt. 7, for a description of secured lending to clearing corporations.

the financial asset in order to achieve this priority.<sup>303</sup> The proponents of Revised Article 8 argue that this provision is necessary to assure lenders who have established “stand-by emergency financing arrangements to enable payment [by a clearing corporation] of the settlement obligations of a defaulting participant” that these arrangements are supported by an “unassailable security interest.”<sup>304</sup>

Insofar as a clearing corporation is a replacement in clearing and settlement for a securities intermediary whose settlement obligation has become that of the clearing corporation,<sup>305</sup> the individual investor’s risk has just been magnified. The individual investor now bears the risk that not only might there be a shortfall at his or her securities intermediary and at all the securities intermediaries up to the depository, but that a totally unrelated settlement default at the clearing corporation may affect the financial assets to which he or she has a security entitlement. Professor Rogers argues that such an event is incredibly unlikely and that the priority rule of revised section 8-511(c) is necessary to prevent the occurrence of such a “horrendous event.”<sup>306</sup> Of course, the individual investor might be forgiven for finding the disappearance of his or her securities entitlement to also be a “horrendous event.” And if enough individual investors were affected seriously enough, systemic risk could be created by their withdrawal from the world of indirectly held securities, i.e., by a run on the bank.

In light of the risks that Revised Article 8’s approach to priority disputes imposes on entitlement holders, one would expect that investors might seek to opt out of the indirect holding system. The practical ability of any investor to opt out of the indirect holding system, of which revised section 8-511 is part, however, is limited.

303. Revised Article 8 justifies the deletion of the control requirement for clearing corporations on two grounds:

The clearing corporation may be the top tier securities intermediary for the securities pledged, so that it would not be practical for the lender to obtain control. Even where the clearing corporation holds some types of securities through other intermediaries, however, the clearing corporation is unlikely to be able to complete the arrangements necessary to convey “control” over the securities to be pledged in time to complete settlement in a timely manner.

*Id.* § 9-115 cmt. 7. Professor Rogers notes that control could not be taken by the secured lender because “[d]oing so would require either physical delivery of certificates to the lender or entries on the books of the issuers of each of the securities in question.” HAWKLAND & ROGERS, *supra* note 31, at 718. Presumably Professor Rogers and the Official Comments are referring to control concepts related to certificated and uncertificated securities because clearing corporations usually hold the securities directly, rather than indirectly.

304. HAWKLAND & ROGERS, *supra* note 31, at 718-19.

305. In the United States, the National Securities Clearing Corporation, for example, which clears 95% of all corporate stocks and bonds, assumes the role of buyer or seller and guarantees settlement of all matched trades. See 1 BANKERS TRUST COMPANY, *supra* note 70, at 34, 36.

306. See HAWKLAND & ROGERS, *supra* note 31, at 718.

## VII. OPTING OUT OF THE INDIRECT HOLDING SYSTEM

An investor could opt out by holding actual paper certificates, rather than holding a securities entitlement with a securities intermediary. For any investor who will be active in the marketplace, this option is impractical.<sup>307</sup> Settlement of most trades in corporate equity and debt securities must be completed within three days of the trade.<sup>308</sup> This short time frame makes it difficult for an investor to deliver the paper certificate to his or her broker in time for settlement. As the goal of the SEC is one-day settlement by the end of the millennium,<sup>309</sup> this practical difficulty will only increase. In addition, many brokers actively discourage their customers from obtaining paper certificates.<sup>310</sup> In the market for United States Treasury bills, notes and bonds, the largest securities market in the United States both in dollar amount and in average daily volume,<sup>311</sup> paper securities have not been issued since August 1986.<sup>312</sup>

Almost all Treasury securities and most securities issued by federal agencies exist only as book entries in a system maintained by the Federal Reserve.<sup>313</sup> In July 1986, the Treasury created the TREASURY DIRECT system that allows investors to register their ownership directly with the Treasury.<sup>314</sup> "The reason for establishing the rights of ownership for securities held in TREASURY DIRECT is that it will give investors the assurance that the forms of registration they select will establish conclusively the rights to their book-entry securities."<sup>315</sup>

On its face, TREASURY DIRECT provides a means for an investor to avoid the dangers of holding Treasury securities indirectly. In practice, however, an investor in TREASURY DIRECT suffers from

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307. See ARTICLE 8 BAR REPORT, *supra* note 6, at 8-9. The committee that drafted the *Article 8 Bar Report*

discussed the extent to which alternate methods of holding securities were available to investors willing to avoid the risks associated with the indirect system. Although the direct holding of paper certificates would have this effect, this often would not be desirable or practicable for investors wishing to be active in the marketplace and should not be held out as a cure.

*Id.*

308. See *supra* note 73.

309. See *id.*

310. See Nancy Ann Jeffrey, *Investors Feel Heat to Keep Securities in "Street Name"*, WALL ST. J., Mar. 2, 1995, at C1.

311. See FEDERAL RESERVE STUDY 1992, *supra* note 69, at 22.

312. Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills (Feb. 22, 1996), 61 Fed. Reg. 8420, 8421 (1996). The Treasury started offering only Treasury bills in book-entry form in December 1976, adding notes and bonds in August 1986. See *id.* at 8420. By December 1995, 99.7 percent of Treasury securities (exclusive of these held in various government trust funds) were held in book-entry form. See *id.* at 8421.

313. See FEDERAL RESERVE STUDY 1992, *supra* note 69, at 22.

314. See Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills (May 15, 1986), 51 Fed. Reg. 18,260 (1986).

315. *Id.*

the same practical disadvantages involving trading as does a paper certificate holder. In order to trade, a member of TREASURY DIRECT must first have his or her interest transferred to TRADES, the indirect holding system for Treasury Securities,<sup>316</sup> or to the Federal Reserve Bank.<sup>317</sup> Although a transfer to the Federal Reserve Bank avoids, as a practical matter, intermediary risk, such transfer is no quicker than a transfer to a TRADES participant,<sup>318</sup> and it is “irrevocable,”<sup>319</sup> thus locking the investor into a sale “on the day that the security is transferred to the Federal Reserve Bank.”<sup>320</sup> This latter requirement provides an investor with considerably less flexibility as compared to having a securities entitlement with a broker-dealer and has led the Department of the Treasury to warn that “[t]he Department and the Federal Reserve Bank are not liable for changes in market conditions which may affect the price received by the investor.”<sup>321</sup> In addition, a participant in TREASURY DIRECT may not grant a security interest in his or her TREASURY DIRECT securities.<sup>322</sup> As the Treasury itself has noted, “TREASURY DIRECT is suited for persons who plan to hold their Treasury securities until maturity.”<sup>323</sup>

Institutional investors have protected themselves against possible misbehavior by securities intermediaries through two separate means. First, the major institutional investors use large commercial banks as custodians.<sup>324</sup> These large commercial banks are believed to have a de facto guaranty against failure from the Federal Reserve.<sup>325</sup> Second, for corporate equity and debt securities, institutional investors that use custodian banks receive direct confirmations from DTC of transactions through DTC’s institutional delivery system.<sup>326</sup> Neither of these protections is available to the average individual investor. Using a custodian bank requires fees that are not large relative to an institutional investor’s holdings but that would be large relative to most individual investors’ holdings.<sup>327</sup> In addition, DTC’s institutional delivery system only functions for institutions, not for individuals.

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316. See 31 C.F.R. § 357.22 (1997).

317. See Regulations Governing Book-Entry Treasury Bonds, Notes and Bills (Aug. 20, 1997), 62 Fed. Reg. 46,860, 46,861 (1997) (to be codified at 31 C.F.R. § 357.22(b)).

318. Compare *id.* at 46,861 (to be codified at 31 C.F.R. § 357.22(b)(3)) with 31 C.F.R. § 357.22(a)(3) (1997).

319. See 62 Fed. Reg. at 46,861 (to be codified at 31 C.F.R. §357.22(b)(9)).

320. *Id.* (to be codified at 31 C.F.R. §357.22(b)(3)).

321. *Id.* at 46,860.

322. 31 C.F.R. § 357.25 (1997).

323. 61 Fed. Reg. at 8423.

324. See Mooney, *supra* note 114, at 324.

325. See STIGUM, AFTER THE TRADE, *supra* note 33, at 221-22.

326. See *id.* at 254.

327. See *id.* at 219-20.

## VIII. REGULATORY AND INSURANCE SCHEMES

Some supporters of Revised Article 8 have relied upon “the continued presence of, other federal and state law, regulation, oversight and enforcement [concerning the relationship between investors and brokers] and the continued availability of SIPC coverage” as premises for passage of Revised Article 8.<sup>328</sup> Other supporters, notably Professor Rogers, have argued that “one’s assessment of the adequacy of these [regulatory and insurance] systems is essentially irrelevant for purposes of understanding and assessing Revised Article 8.”<sup>329</sup>

Professor Rogers’ main point is that Revised Article 8 is concerned with the traditional commercial law goal of ensuring finality in securities transfers, thereby controlling systemic risk.<sup>330</sup> As this Author does not share Professor Rogers’ assessment of Revised Article 8’s

328. See ARTICLE 8 BAR REPORT, *supra* note 6, at 10; see also Mooney, *supra* note 114, at 313 (smaller, less sophisticated investors are protected by SIPA). The legislative history preamble to the bill enacting Revised Article 8 in New York relies explicitly on “continued active oversight by agencies of the federal and state governments and the continued availability of the securities investor protection corporation . . . and the SIPC fund . . . to protect investors from loss” in its declaration of legislative intent explaining the enactment of Revised Article 8. See Uniform Commercial Code-Investment Securities, 1997 N.Y. Laws 566, § 1. The preamble goes on to state that “[i]f the federal or state government alters or reduces its role as protector of shareholders and other participants in the securities market, then the state may need to enact laws in addition to article 8 of the uniform commercial code to address these issues.” *Id.* Presumably in order to provide the legislature with the information necessary to effectuate this legislative intent, the bill enacting Revised Article 8 in New York provides that

[t]he attorney general shall issue a report on or before June first of each year to the governor, the comptroller, the speaker of the assembly, and the temporary president of the senate on the assets and condition of the securities investor protection corporation (SIPC) . . . and the [SIPC] fund . . . its adequacy to meet losses that New York state residents may incur, and any material changes that have occurred in the coverage structure or funding of SIPC in the year preceding the report.

*Id.* § 28. This Author is skeptical that any substantial resources will be devoted to generating this report, as substantial resources were not devoted to studying Revised Article 8 before its adoption in New York.

329. Rogers, *supra* note 7, at 1539. Professor Rogers simultaneously makes the empirical claim that the Securities Investor Protection Act (SIPA) is an effective insurance system. See *id.* at 1538. If SIPA is relevant, then Professor Rogers and other proponents should seriously evaluate its effectiveness. If it is not relevant, then proponents should not attempt to backdoor in claims of effectiveness. Professor Rogers repeats this approach when discussing the collusion standard under Revised Article 8:

To be perfectly frank, the author suspects that the question of the precise meaning of the collusion standard will for *all time* remain a matter for academic speculation concerning hypotheticals. Given the existence of the elaborate regulatory system under which securities intermediaries operate, it seems relatively unlikely that many, or even any, litigated cases will actually arise in which courts would be called upon to interpret and apply the collusion standard of subsection 8-503(e).

HAWKLAND & ROGERS, *supra* note 31, at 630 (emphasis added).

330. See Rogers, *supra* note 7, at 1539 (“The basic policy of present law and Revised Article 8 is that the commercial law rules should be designed to ensure finality.”).

role in limiting systemic risk, nor his view that Revised Article 8 is essentially irrelevant to protecting investors, this Article assumes that the insurance coverage provided by the Securities Investor Protection Act (SIPA), which established the Securities Investor Protection Corporation (SIPC), and the SEC's rules covering a broker's capitalization and treatment of a customer's securities and cash are relevant in evaluating Revised Article 8. This Article focuses on the SEC in examining the regulatory issues. There are other relevant regulatory agencies and bodies of rules promulgated by these agencies. The most notable are the Federal Reserve Bank and the Department of the Treasury, both of which play important roles in the United States Treasury securities markets.<sup>331</sup> This Author, however, does not believe that the issues raised in this Article would be materially affected by separately discussing each relevant regulatory agency and its rules.

From 1967 to 1970, the securities industry underwent a profound "back-office" crisis.<sup>332</sup> Trading volumes rose to record highs and broker-dealers were unable to deal with the increasing number of transactions.<sup>333</sup> Although SEC and self-regulatory organization (SRO) rules covering the capitalization of broker-dealers, record keeping by broker-dealers, and the safekeeping of customers' securities predated the paperwork crisis,<sup>334</sup> and major stock exchanges had instituted voluntary trust funds to protect customers, both the regulatory regime and the private trust funds were found lacking. For example, prior to 1975, the SEC exempted from its net capital rules members of securities exchanges that imposed capital requirements more rigorous than those of the SEC.<sup>335</sup> But the NYSE, for one, failed to enforce its rule regarding capital requirements during the paperwork crisis. This failure led to Congress authorizing, and the SEC promulgating in 1975, the Uniform Net Capital Rules.<sup>336</sup>

Similarly, the voluntary trust funds failed during the paperwork crisis to protect all customers of broker-dealers due to three prob-

331. See generally GAO, TREASURY SECURITIES, *supra* note 265, at 56-65 (describing roles of the Treasury, Federal Reserve, OCC, Federal Deposit Insurance Corporation, CTFIC, and SEC in this area).

332. See generally SIDNEY M. ROBBINS ET AL., PAPER CRISIS IN THE SECURITIES INDUSTRY: CAUSES AND CURES (1969) (explaining the causes of the crisis and suggesting solutions to prevent future problems).

333. See *id.* at 21-51. The "paperwork crisis" also was an impetus behind 1977 Article 8. See Peter F. Coogan, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013, 1017 (1979).

334. See generally Allan Gates, Comment, *The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection*, 24 VAND. L. REV. 586 (1971) (describing the regulatory framework prior to enactment of SIPA).

335. See Steven L. Molinari & Nelson S. Kibler, *Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1, 7-8 (1983).

336. See *id.* at 15-16, 15 n.94.



lems. First, the trustees had no legal obligation to the customers of member firms, maintaining discretion as to disbursements; second, the trust funds had limited financial resources; and finally, the trust funds did not cover non-exchange members' customers.<sup>337</sup>

During the period from 1970 to 1975, Congress and the SEC took a number of important steps to strengthen customer protections, creating the framework upon which proponents of Revised Article 8 have relied.<sup>338</sup> In 1970, Congress passed SIPA.<sup>339</sup> SIPA had two separate goals, the first of which was to clarify and strengthen the SEC's authority to regulate broker-dealers. SIPA did this by amending section 15(c)(3) of the 1934 Act to cover over the counter broker-dealers and to clarify the SEC's authority to promulgate rules concerning not just the "financial responsibility" of broker-dealers, but also concerning "related practices" of broker-dealers.<sup>340</sup> In particular, Congress wanted to clearly establish the SEC's authority "to adopt rules dealing with free credit balances and segregation of securities."<sup>341</sup> In late 1972, the SEC adopted Rule 15c3-3,<sup>342</sup> the customer protection rule providing for segregation by broker-dealers of customer securities and cash balances from the broker-dealers' own property, which is discussed in greater detail in Part VIII of this Article. And, as was just mentioned, in 1975 the SEC reasserted its direct supervisory authority over broker-dealers' net capital.

SIPA's second goal was to create the SIPC, a nonprofit corporation consisting of all broker-dealers registered under section 15(b) of the 1934 Act.<sup>343</sup> The SIPC was charged with creating a "SIPC Fund" from

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337. See HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INVESTOR PROTECTION ACT OF 1970, H.R. REP. 91-1613, at 3 (1970), *reprinted in* 1970 U.S.C.A.N. 5254, 5257; SENATE COMM. ON BANKING AND CURRENCY, SECURITIES INVESTOR PROTECTION CORPORATION, S. REP. 91-1218, at 3 (1970). These concerns were not merely theoretical. As of October 1970, the NYSE, for example, had refused reimbursement from its trust fund for the customers of three members or former members that had failed since August 1970, arguing that the trust fund was voluntary and there were no further funds available. See H.R. REP. 91-1613 at 3.

338. See generally Molinari & Kibler, *supra* note 335 (primarily describing the SEC's regulatory regime); see also Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers*, 12 CARDOZO L. REV. 509 (1990) (describing SIPC and the insurance scheme).

339. 15 U.S.C. §§ 78aaa-78lll (1994).

340. Act of Dec. 30, 1970, § 7(d), 84 Stat. 1636, *reprinted in* 1970 U.S.C.A.A.N. 1905, 1926.

341. H.R. REP. 91-1613 at 14, *reprinted in* 1970 U.S.C.A.A.N. 5254, 5267.

342. Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release 34-9856 (Nov. 17, 1972), 37 Fed. Reg. 25,224 (1972). Rule 15c3-3 was the result of a political process that had begun in 1939 with the SEC proposing a "brokerage bank" that was "designed to take over from brokers all the banking and credit functions which they then performed." HURD BARUCH, WALL STREET: SECURITY RISK 57 (1971). Resistance from the financial industry caused the SEC to withdraw this concept. *Id.* By 1941, the SEC was proposing segregation rules similar to those enacted three decades later. *Id.* at 58-61.

343. See 15 U.S.C. § 78ccc(a)(1) (1994).

assessments imposed upon its members<sup>344</sup> and given broad powers to liquidate broker-dealers whose continued operations might jeopardize customers.<sup>345</sup> The SIPC Fund is to be used to make advances of up to \$500,000 for a customer's claim for securities and cash, of which up to \$100,000 may be for a cash claim, to a trustee that is liquidating a broker-dealer under SIPA.<sup>346</sup> These advances, which are made when there are shortfalls in "customer property" held by the broker-dealer being liquidated, function as insurance.<sup>347</sup>

The proponents of Revised Article 8 have given almost no account of either the insurance or the regulatory scheme to demonstrate why these schemes form an effective investor protection regime. Perhaps this is not so surprising when one realizes the paucity of secondary materials on those two important but relatively obscure areas.<sup>348</sup> But

344. See *id.* § 78ddd(a)(1).

345. See *id.* § 78eee.

346. See *id.* § 78fff-3.

347. SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 572 (3d Cir. 1977) ("The SIPA was enacted for the protection of brokerage customers. In a loose, nontechnical sense, it provides benefits to them somewhat similar to insurance against the broker's insolvency, although not against the vagaries of the market.") (footnote omitted).

348. In the four years subsequent to the enactment of SIPA, there were a handful of law review articles. See, e.g., David M. Greenberg, *An Analysis of the Securities Investor Protection Act of 1970*, 16 HOW. L.J. 907 (1971); Roberta S. Karmel & Jeffrey M. Weissman, *Taking Stock of the Court's Jurisdiction in a SIPA Liquidation*, 41 BROOK. L. REV. 1 (1974); Hugh L. Sowards & James S. Mofsky, *The Securities Investor Protection Act of 1970*, 26 BUS. LAW. 1271 (1971); *The Securities Investor Protection Act of 1970: An Early Assessment*, 73 COLUM. L. REV. 802 (1973); Gates, *supra* note 334; Note, *The Securities Investor Protection Act (How The S.I.P.C. Fared in the First Four Years of Its Existence)*, 7 U. WEST L.A. L. REV. 162 (1975). Subsequently, there have been only a few additional articles on the SIPC, including Harold S. Bloomenthal & Donald Salcito, *Customer Protection From Brokerage Failures: The Securities Investor Protection Corporation and the SEC*, 54 U. COLO. L. REV. 161 (1983); Bartley A. Brennan, *The Role of SIPC in Brokerage Failures: A Case Study of the Demise of Bell and Beckwith*, 13 SEC. REG. L.J. 18 (1985); Don & Wang, *supra* note 338; Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court Under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277 (1982); Michael D. Bolton, Note, *Repurchase Agreement Transactions in Securities Investor Protection Act Proceedings*, 15 FORDHAM URB. L.J. 359 (1987); Sheila Cheston, Note, *Investor Protection Under the SIPA: A Reassessment and Recommendations for Future Change*, 19 COLUM. J.L. & SOC. PROBS. 69 (1985), and one good general study, UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-92-109, SECURITIES INVESTOR PROTECTION: THE REGULATORY FRAMEWORK HAS MINIMIZED SIPC'S LOSSES (1992) [hereinafter GAO 1992].

There are at least four treatises besides Louis Loss and Joel Seligman's *Securities Regulation* that discuss the federal regulation of broker-dealers. Of them, one has not been updated in twenty years, see NICHOLAS WOLFSON ET AL., *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* (1977), while the second only devotes one chapter to broker-dealer regulation, see RALPH S. JANVEY, *REGULATION OF THE SECURITIES AND COMMODITIES MARKETS* 4-3 to 4-113 (1992); the third hardly mentions the net capital and various customer protection rules, see DAVID A. LIPTON, *BROKER-DEALER REGULATION* (1988); and the fourth has only three brief discussions of the net capital and customer protection rules and has not been comprehensively updated in twenty years, see SHELDON M. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS: A GUIDE TO THE REGULATORY PROCESS* 156-158, 270-289 (1977).

the assumption that is made, namely that the SIPC and SEC regulation provide adequate investor protection, is disturbing when there has been no evaluation of their respective strengths and weaknesses. The *Article 8 Bar Report* is particularly egregious in this respect for failing to cite even the few available secondary services when making the bald claim that SIPC coverage and SEC regulation have adequately protected investors.<sup>349</sup> As Revised Article 8 was in process for six years, one could have expected that some empirical work would have been done on this issue.<sup>350</sup> Regrettably, none was undertaken.

This Article does not attempt to rectify the deficiencies of the materials prepared by proponents of Revised Article 8 by presenting a full analysis of SIPA insurance coverage or the SEC's regulatory regime. Rather, it attempts to show that there are substantial questions concerning the adequacy of SIPA insurance coverage and the SEC's regulatory regime, questions that deserved a full hearing before too much weight was placed on such potentially weak reeds.

### A. SEC Customer Protection

#### 1. In General

It is appropriate to start with the SEC's regulatory regime as the SIPC and the SIPA Fund are conceived of as a "back-up" to "the regulatory framework—including the net capital and customer protection rules—[which] serves as the primary means of customer protection."<sup>351</sup> Congress saw this clarification of SEC authority contained in SIPA and the regulatory measures that should follow as the primary means of protecting investors. "It is clear that the protections to investors provided by the proposed SIPC fund are really only an interim step. The long-range solution to these problems confronting the industry today is going to be found in the ultimate raising of the financial responsibility of the brokerage community."<sup>352</sup>

The SEC's substantive regulation of broker-dealers includes extensive rules meant to protect customers' funds and securities. These

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The law review literature that focuses on the uniform net capital rules is even less extensive than that for the SIPC. See, e.g., Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863 (1992); Nelson S. Kibler & Steven L. Molinari, *The SEC's Recent Revisions to Its Uniform Net Capital Rule and Customer Protection Rule*, 10 SEC. REG. L.J. 141 (1982).

349. ARTICLE 8 BAR REPORT, *supra* note 6, at 9-10.

350. See *infra* Part VIII for further discussion of this point.

351. GAO 1992, *supra* note 348, at 22. The uniform net capital rule promulgated in 1973 was intended to both "enhance the protection of customer funds and securities held by broker-dealers . . . [and] to protect the SIPC fund by requiring all broker-dealers to operate under a sound capital base." Net Capital Rule: Proposed Uniform and Comprehensive Regulation, Exchange Act Release 34-9891 (Dec. 5, 1972), 38 Fed. Reg. 56 (1973).

352. H.R. REP. 91-1613 at 12 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5266.

rules cover record keeping;<sup>353</sup> financial reports;<sup>354</sup> net capital;<sup>355</sup> early warning to the SEC and the designated SRO of certain net capital, record keeping or reporting violations,<sup>356</sup> segregation and reserve requirements for customer securities and funds;<sup>357</sup> use of customer free credit balances;<sup>358</sup> quarterly box counts of securities;<sup>359</sup> and hypothecation of customer securities.<sup>360</sup> This article will briefly discuss only the rules that are most important for customer protection: Rules 15c3-1 (uniform net capital),<sup>361</sup> 15c3-3 (segregation of customer securities and funds), and 15c2-1 and 8c-1 (companion rules dealing with hypothecation of customer securities).

Three initial points should be noted. First, supporters of Revised Article 8, who rely on the SEC's support for Revised Article 8 to argue for its passage,<sup>362</sup> also rely on the presence of an effective SEC regulatory regime to argue that Revised Article 8 does not need to be concerned with protecting investors.<sup>363</sup> An extraordinary legitimacy is being accorded the SEC's views and policies. No consideration is given by the proponents of Revised Article 8 to whether the SEC has an agenda other than investor protection. There are potential issues of capture of the regulatory agency by interest groups,<sup>364</sup> which may

353. See LOUIS LOSS & JOEL SELIGMAN, 7 SECURITIES REGULATION 3107-16 (3d ed. 1991).

354. See *id.* at 3117-28.

355. See *id.* at 3137-57.

356. See *id.* at 3157-60.

357. See *id.* at 3160-75.

358. See *id.* at 3175-76.

359. See *id.* at 3176-79.

360. See *id.* at 3179-90.

361. The SEC is currently studying "whether the net capital rule should be amended to allow firms to use statistical models to calculate net capital requirements." Net Capital Rule, Exchange Act Release No. 34-39456 (Dec. 17, 1997), 62 Fed. Reg. 68,011, 68,012 (1997). The net effect of such an approach would be "that a firm would be able to recognize, to a greater extent, the correlations and hedges in its securities portfolio and have a comparatively smaller capital charge for market risk." *Id.* at 68,015.

362. See, e.g., Shupack Letter, *supra* note 257, at 12.

363. "The new statute was drafted within a context in which an intricate federal regulatory scheme governing securities intermediaries exists, and in which substantial protection is given to any customer of a securities intermediary by federal and state statutes." *Id.*

364. A regulatory agency can be captured by a public lobby, including pro-consumer groups, as well as by the regulated industry. RICHARD A. HARRIS & SIDNEY M. MILKIS, THE POLITICS OF REGULATORY CHANGE: A TALE OF TWO AGENCIES 154-86 (2d ed. 1996). Whether the SEC has been captured has been a matter of some discussion. Compare JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET xi (1982) (The SEC is not "a 'captive' of the industries it regulates. Quite simply, such a suggestion cannot be sustained by a reasonable reading of the Commission's history."), with SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 21-23 (1981) (applying public choice theory to argue that the public interest has not been "an important consideration in the [SEC's] regulatory process"). One commentator has gone so far as to argue that the SEC is an obsolete agency due to fundamental changes in America's capital markets, which has led to its capture by interest groups. See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 948-49 (1994).

(but do not have to) include the regulated industry, and conflicting congressionally mandated goals for the SEC. The SEC has a mandate to improve market efficiency as well as to protect investors. These two goals may, at times, conflict and the SEC must make a value judgment favoring one over the other.<sup>365</sup> And, of course, the balance between efficiency and investor protection in the SEC's decision making is not a fixed equation and may change over time.<sup>366</sup> The literature supporting Revised Article 8 does not include any discussion of these issues.

Second, the relevant universe for examination is not just the SEC itself but, perhaps more importantly, the activities of the SROs to which almost all broker-dealers belong.<sup>367</sup> Federal securities regulation is not a matter of SEC action alone. In fact, federal securities regulation is a two level affair. The SROs have their own rules and provide much of the day-to-day supervision of broker-dealers' compliance with federal securities rules.<sup>368</sup> The SEC oversees SROs by, among other things, conducting oversight broker-dealer examinations to reexamine broker-dealers that have already been examined by SROs, thus checking SRO examination results;<sup>369</sup> inspecting the

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From an individual investor's perspective, the problem with the SEC is that so few individual investors participate in SEC rule making. UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-86-83, SECURITIES REGULATION: SECURITIES AND EXCHANGE COMMISSION OVERSIGHT OF SELF REGULATION 55 (1986) [hereinafter GAO, SEC 1986]. The SEC has reported that "small investors rarely comment on proposed [SRO] rule changes" but that this is not a problem in reviewing SRO rule changes because the SEC officials "believed that they themselves adequately represented the interests of the small investor in the rule review process." *Id.* This is a statement for which this Author is unaware of any well-developed support. One might expect pension funds to act as a proxy for small investors except for the fact that these institutional investors have pursued strategies to insulate themselves from the risks of financial intermediary misbehavior in the indirect holding system that are different from those available as a practical matter to individual investors. *See supra* Part VI.B.

365. *See* Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315 (1985). This Article takes no position on Professors Macey and Haddock's basic point that the SEC has used the "public interest" as a subterfuge to disguise its search to maximize its political support by favoring certain "special interests" in the securities industry. *See id.* at 361-62.

366. Another possible dichotomy in the SEC's goals of potential importance to evaluating its regulatory regime is between its functions in promoting full disclosure by market participants and in regulating the market. The SEC has been a signal success in "provid[ing] investors with the information needed to trade intelligently in markets free of fraud and other abuse." Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 755 (1984). In contrast, the SEC has not been as successful in its "attempt to ensure the effective and responsible operation both of those [securities] markets and of the securities industry." *Id.*

367. The two best-known SROs are, of course, the NYSE and the National Association of Securities Dealers (NASD).

368. LOUIS LOSS & JOEL SELIGMAN, 6 SECURITIES REGULATION 2692-2705 (Stock Exchanges), 2787-94 (securities associations in general), 2795 n.24 (NASD) (3d 1991).

369. GAO, SEC 1986, *supra* note 364, at 20-29. In addition, the SEC performs cause examinations in response to customer complaints or other information. *See id.* at 20.

SROs themselves to examine SRO procedures;<sup>370</sup> and reviewing SRO proposed rules.<sup>371</sup> Insofar as concerns with regulatory capture should be considered with the respect to the SEC, they are even more pertinent to the SROs, which are membership organizations.<sup>372</sup> Nowhere do the supporters of Revised Article 8 discuss these issues on either a theoretical or an empirical level.

Finally, there is an issue of whether the SEC's regulation of financial service firms is comprehensive enough to provide meaningful protection to "U.S. investors and the financial system."<sup>373</sup> Large broker-dealers have greatly expanded the range of their activities and have become members of complex financial institutions,<sup>374</sup> while SEC regulations have remained focused only on the broker-dealer components of financial service firms.<sup>375</sup> Without a "careful analysis . . . of the . . . nature and size of activities done outside broker-dealers" it is impossible to know what risks are posed by the limited range of SEC regulation.<sup>376</sup> Of particular relevance to Revised Article 8 is an examination of the adequacy of net capital rules in light of the change in the nature of the business and organizational forms of large broker-dealers. Although the SEC is working on the issue of regulatory coverage, it has made no public report yet.<sup>377</sup> As the GAO concluded in 1992, "Determining the risks these activities pose, and developing an appropriate regulatory response, should be done as soon as possible."<sup>378</sup>

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370. *See id.* at 30-39.

371. *See id.* at 40-47.

372. *See generally* Sam S. Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985) (describing securities industry SROs and problems associated with their operation).

373. GAO, SECURITIES FIRMS, *supra* note 124, at 2.

374. *See id.* at 29-46.

375. *See id.* at 51.

376. *Id.* at 83.

377. This is not surprising in light of the GAO's concerns in 1992 that the "SEC may have already determined, without first collecting and analyzing the data, that just obtaining information is the preferred approach" to reforming its regulatory scheme and that the SEC has no "time frame to implement its approach." *Id.* at 84-85. To date, all the SEC has accomplished is the creation of a risk assessment record keeping and reporting system for broker-dealers and their Material Associated Persons. *See* 17 C.F.R. §§ 240.17h-1T, 17h-2T (1999). Similar record keeping and reporting systems have been established for futures commission merchants, *see* 17 C.F.R. §§ 1.14, 1.15 (1999), and registered government securities brokers and dealers, *see* 17 C.F.R. §§ 404.2(b), 405.5 (1999).

378. GAO, SECURITIES FIRMS, *supra* note 124, at 85. The debate over whether regulation of financial derivatives is appropriate and whether there should be a single regulator for financial derivatives and securities is a separate, albeit related, debate. *See generally* Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279 (1997) (ascribing persistence of multiple financial regulators to a combination of Congressional committee turf protection, lack of widespread public interest in derivatives and an alliance among farm groups, future exchanges and banks); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1 (1996) (describing current regulatory regimes for derivative securities).

A 1986 GAO study indicates that these empirical issues deserve further exploration.<sup>379</sup> Although the GAO did not express any serious reservations concerning the SEC's oversight of SROs, it did note several troubling facts. In the early 1980s, the failure rate of SROs in detecting broker-dealer securities law violations increased.<sup>380</sup> In addition, it was unclear how serious these violations were, as the SEC had no system for tracking the gravity of these violations.<sup>381</sup> Most importantly for evaluating Revised Article 8, these undetected violations were most heavily concentrated in "recordkeeping, net capital computations, miscellaneous provisions of the customer protection rule, and financial reporting."<sup>382</sup> These are exactly the areas of SEC regulation that proponents of Revised Article 8 rely on in arguing that investors do not need any substantial independent protection in Revised Article 8. It should be noted that the GAO examined the sixteen failures in 1983 and 1984 of broker-dealers involving the SIPC<sup>383</sup> and "found that missed violations were generally not a significant factor in the failures."<sup>384</sup> This Author is not aware of any authoritative work that updates this eleven-year-old GAO study.<sup>385</sup> And without an updated study, what conclusion can be drawn concerning the robustness of the SEC's oversight of the SROs?

Furthermore, the supporters of Revised Article 8 fail to discuss the impact of the anti-regulatory movement born in the Reagan administration on the SEC's ability to function. This is particularly surprising considering the extensive scholarly writing on this topic,<sup>386</sup> although not on the SEC in particular. Although the ultimate import of this anti-regulatory movement is far from clear,<sup>387</sup> it has affected, at a minimum, SEC funding and staffing.<sup>388</sup>

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379. See GAO, SEC 1986, *supra* note 364.

380. See *id.* at 21-22 (examining 1982-84).

381. See *id.* at 22-23.

382. *Id.* at 22 (footnote omitted).

383. See *id.* at 15.

384. *Id.* at 26.

385. In 1991, another study was released that, by its title, seems to support the conclusion that the SEC's oversight procedures work well. See UNITED STATES GENERAL ACCOUNTING OFFICE, GAD/GGD-92-17, SECURITIES REGULATION: CUSTOMER PROTECTION RULE OVERSIGHT PROCEDURES APPEAR ADEQUATE (1991). This study, however, only described the SEC procedures; it did not attempt to evaluate their effectiveness. See *id.* at 1.

In addition, the study did not evaluate the requirement that broker-dealers establish a special reserve bank account for customers. See *id.* at 4 n.7. Finally, although the total number of regulatory violations was not known, the study reported that the "SEC, NYSE, and NASD have found numerous broker-dealer violations of possession or control requirements over the last 3 years." *Id.* at 7.

386. See, e.g., HARRIS & MILKIS, *supra* note 364 (discussing the FTC and EPA); Michael Fix, *Transferring Regulatory Authority to the States*, in RELIEF OR REFORM? 207-34 (George C. Eads & Michael Fix eds., 1984).

387. While the EPA, for example, suffered significant "budgetary cutbacks, reductions in enforcement actions, and the near-elimination of new regulations, the institutions and policies of the public lobby regime held firm." HARRIS & MILKIS, *supra* note 364, at 275.

The decline in the early 1980s in the SEC's resources took place while the trading volume, transaction numbers, individual investor participation, and the number of broker-dealers all increased materially.<sup>389</sup> While the SEC's resources have increased since the mid-1980s,<sup>390</sup> they have failed to increase at a rate even remotely comparable to the tremendous growth of the securities markets.<sup>391</sup> The lack of an increase in SEC resources is particularly troubling because of the increased involvement of individual investors in the securities markets in the last seven years<sup>392</sup> combined with increased trading volumes.<sup>393</sup> As the GAO noted in 1986, commenting on a similar phenomenon ten years earlier:

Very recently individual investors have increased their trading, encouraged by a continued upward movement of the market. Growth in the number of transactions is important because a transaction, as the interaction of an investor with market professionals, is one of the basic activities that must be watched for potential problems.<sup>394</sup>

As a result of these financial constraints, in the mid-1980s, the SEC was only able to audit five to eight percent of broker-dealers each year through its oversight examination program.<sup>395</sup> This is not surprising when one realizes that there were only 100 SEC examiners for approximately 8,000 broker-dealers.<sup>396</sup> The ratio of examiners

The Reagan administration had achieved, in this interpretation, "temporary regulatory relief rather than lasting regulatory change." *Id.* But see Fix, *supra* note 386, at 207-34 (noting that the Reagan administration succeeded in shifting responsibility for certain environmental problems to states, which in many areas have not been as activist as the EPA).

388. See GAO, SEC 1986, *supra* note 364, at 58-60.

389. See *id.*

390. In fiscal year 1982, the SEC had 1,882 positions and a budget of approximately \$83 million. See SEC, 1982 ANNUAL REPORT iii-iv. By fiscal year 1994, the SEC had 2,775 positions and a budget of approximately \$256 million. See SEC, 1994 ANNUAL REPORT 160.

391. In the period from 1982 to 1993, looking only at share trading on exchanges, the number of shares traded increased from 22,491,935,000 shares to 83,056,237,000 shares, see SEC, 1994 ANNUAL REPORT 155, and the dollar volume increased from \$603,094,266,000 to \$2,610,504,390,000, see *id.* at 156.

392. See Press Release from NASDAQ (Feb. 21, 1997), *Number of Investors Has Doubled to 43 Percent in Past Seven Years, According to Comprehensive Shareholder Survey* (on file with author). This press release headline with its "43 percent" figure reported the results of a random sample of over 1000 adults. Telephone Interview with Guy Molyneux, Peter Hart Associates (July 9, 1997).

393. From 1994 to 1996, on the NYSE alone, reported share and dollar volume grew from 73,420,401,000 shares and \$2,454,241.6 million volume to 104,636,180,000 shares and \$4,063,054.6 million volume. NYSE, FACT BOOK FOR THE YEAR 1996 11 (1997).

394. GAO, SEC 1986, *supra* note 364, at 59.

395. See UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-86-26, SECURITIES AND FUTURES: HOW THE MARKETS DEVELOPED AND HOW THEY ARE REGULATED 51 (1986).

396. See *id.* The scarcity of SEC resources has led one defense lawyer to propose "neatness" as a preventive measure because SEC "inspectors often must rely on a first impression of a registrant, based on the appearance of its records, to determine whether an intensive inspection of that registrant is warranted." Richard D. Marshall, *SEC Inspections: The*



to broker-dealers has not changed.<sup>397</sup> The SEC has taken several steps to use its scarce resources more effectively. It has centralized its inspection staff into the Office of Compliance Inspections and Examinations, whose director reports to the SEC chairman.<sup>398</sup> In addition, the SEC has entered into Memoranda of Understanding with certain SROs and the comptroller of the currency to coordinate broker-dealer inspections and has entered into joint declarations with certain overseas securities regulators about inspecting foreign advisers.<sup>399</sup> This Author is unaware of any study evaluating the effectiveness of these measures.

## 2. *Specific Rules*

Finally, mention should be made of problems in the SEC's rules themselves. This discussion is not meant to serve as a thorough exploration of potential problems; its goal is merely to indicate that there are issues that require thorough study before one can, as do the supporters of Revised Article 8, take comfort in the assurance that the federal regulatory regime adequately protects small investors. In discussing whether the segregation rule could supplant the net capital rule, the SEC itself has identified a number of theoretical and practical problems in the customer protection rule.<sup>400</sup> In gaining possession or control of securities, there are "pronounced delays."<sup>401</sup> In addition, "examination by the Commission and self-regulatory organizations have found substantial and continuing violations of Rule 15c3-3 and an apparent lack of understanding of the rule among some brokers and dealers some eight years after the rule's adoption."<sup>402</sup> Furthermore, many broker-dealers liquidated by the SIPC

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*Preventable Prelude to Enforcement Action*, in THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 11, 18 (Richard M. Phillips ed., 1997).

397. In 1994, "[t]he SEC completed a total of 680 examinations, consisting of 478 oversight and 202 cause examinations." SEC, 1994 ANNUAL REPORT 34. As there were over 8,600 registered broker-dealers, *see id.* at 28, in 1994 the SEC conducted oversight examinations of approximately 5.5% of these broker-dealers. The quality of the SEC's empirical studies of the securities industry has also greatly declined in the past decade. *See* Joel Seligman, *Another Unspecial Study: The SEC's Market 2000 Report and Competitive Developments in the United States Capital Markets*, 50 BUS. LAW. 485, 485-92 (1995) (criticizing *Market 2000: An Examination of Current Equity Market*, the SEC's most recent overall study of the securities markets, for its lack of comprehensiveness, inadequate research and presentation of the research that was done and lack of independence of the study's staff). This lack of rigor in *Market 2000* may be a reflection of deficiencies in the SEC's resources. At the very least, this lack of rigor cautions against too great a reliance on the SEC's formulation of the issues in clearance and settlement of securities and their resolution.

398. Establishment of Office and Delegation of Authority to Administer Functions, Exchange Act Release No. 34-36031 (July 28, 1995), 60 Fed. Reg. 39,643 (1995).

399. *See* Marshall, *supra* note 396, at 25-26.

400. Net Capital Requirements for Brokers and Dealers; Amended Rules, Exchange Act Release 34-18417 (Jan. 13, 1982), 47 Fed. Reg. 3512, 3514 (1982).

401. *Id.*

402. *Id.*

“did not make the required deposits as they approached financial difficulty.”<sup>403</sup> Finally, the SEC noted that the calculation of the Reserve Formula is only done weekly, and the required deposit is made three calendar days later.<sup>404</sup>

The segregation rule also allows a broker-dealer to oversecure a margin loan by forty percent. In practical terms, this means that a broker-dealer does not have to obtain physical possession or control of securities whose market value is equal to this forty percent.<sup>405</sup>

The hypothecation rules<sup>406</sup> contain their own problems. For example, two of the general prohibitions of Rules 8c-1 and 15c2-1 only apply when a customer’s securities have not been commingled with those of the broker-dealer or other customers.<sup>407</sup> In addition, the third general provision of the two hypothecation rules only protects customers against hypothecations that “exceed[ ] the aggregate indebtedness of *all* customers.”<sup>408</sup> As the leading securities law treatise notes, “theoretically, a broker-dealer owed \$100,000 in margin accounts by all customers could hypothecate one customer’s securities

403. *Id.*

404. *Id.* The SEC was summarizing Rule 15c3-3(e)(3). See 17 C.F.R. § 240.15c3-3(e)(3) (1999). Until the late 1980s, the securities industry used the weekly deposit requirement to reduce its weekly reserve requirements. Broker-dealers would obtain loans secured by customer securities on the next business day after the weekly rule 15c3-3(e) calculation. These loans would be repaid with unsecured loans just before the weekly calculation. This process was repeated each week. See *Upton v. SEC*, 75 F.3d 92, 94, 97 (2d Cir. 1996).

Both the SEC and the SROs took actions to close this loophole. In 1986 the SEC began investigating this practice and in 1987 brought a proceeding against a broker-dealer for exploiting this loophole. See *In re Underwood, Newhaus & Co.*, Exchange Act Release No. 34-25531, 40 S.E.C. Docket 785 (Mar. 30, 1988). In the appeal from this proceeding, the Second Circuit held that, although this pay down practice was in literal compliance with Rule 15c3-3(e), the SEC was entitled to make a broad interpretation that would reduce the “substantial risk” customers were exposed to for most of the week. See *Upton*, 75 F.3d at 97. In 1989, the NYSE notified its members that this pay-down practice could violate Rule 15c3-3(e). See NYSE, *Broker-Dealer Censured for Violation of SEC Rule 15c3-3 and Discussion of the Intent and Objective of the Rule*, Interpretation Memo 89-10 (Aug. 23, 1989).

405. Rule 15c3-3(a)(5) defines “excess margin securities” as “those securities referred to in paragraph (a)(4) of this section [defining “margin securities”] carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer’s account or accounts encompassed by paragraph (a)(4).” 17 C.F.R. § 240.15c3-3(a)(5) (1999). The 140% comes from bank lending practices at the time of enactment of Rule 15c3-3. If a bank would only loan 75% of the fair market value of a security, it required approximately \$140 worth of securities to secure a \$100 loan. See WOLFSON ET AL., *supra* note 348, at ¶ 7.02[1][a] n.22.

406. See 17 C.F.R. § 240.8c-1 (1999); 17 C.F.R. § 240.15c2-1 (1999). Two rules, both identical in language, were adopted because section 8 of the 1934 Act applies only to a “registered broker or dealer, member of a national securities exchange, or broker or dealer who transacts a business in securities *through* the medium of any member of a national securities exchange,” 15 U.S.C. § 78h (1994) (emphasis added), while section 15 applies to any “manipulative, deceptive, or other fraudulent device or contrivance” by any “broker or dealer” in connection with “any transaction in . . . any security . . . *otherwise* than on a national securities exchange,” 15 U.S.C. § 78o(c) (1994) (emphasis added).

407. See 17 C.F.R. §§ 240.8c-1(a)(1), (a)(2); 240.15c2-1(a)(1), (a)(2) (1999).

408. *Id.* §§ 240.8c-1(a)(3); 240.15c2-1(a)(3) (emphasis added).

for that sum even though that one customer owed a much lesser amount.<sup>409</sup> Customers are not necessarily left without legal protection in these situations. Rule 15c3-3, the segregation rule, may override the hypothecation rules through its requirements that a “broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers.”<sup>410</sup> Some commentators have read the segregation rule and the hypothecation rules in this way.<sup>411</sup> But it should be noted that the SEC also proposed amendments to the hypothecation rules in 1971, the same release first proposing Rule 15c3-3, that would have restricted hypothecation or stock lending in a manner consistent with Rule 15c3-3.<sup>412</sup> The SEC, however, never adopted these restrictions. Accordingly, it is just as consistent with the regulatory history to argue that the hypothecation rules override the segregation rule as it is to assert the converse. Due to the conflict between Rule 15c3-3 and the hypothecation rules, it is possible that whatever protection exists is afforded by state, not federal, law.<sup>413</sup> The irony of this legal situation would probably be lost on supporters of Revised Article 8, as they have such an *a priori* faith in the efficacy of SEC regulation.

Not only are there gaps in the SEC’s rules that could affect investors, but the enforcement of these rules rests with the SEC and the SROs. Courts have been unsympathetic to plaintiffs bringing private causes of action under the segregation or hypothecation rules.<sup>414</sup> Although rare exceptions exist,<sup>415</sup> most courts have held, under a variety of factual circumstances and legal theories, that section 15 of the 1934 Act does not give rise to a private cause of action.<sup>416</sup> The empiri-

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409. LOUIS LOSS & JOEL SELIGMAN, 7 SECURITIES REGULATION 3190 n.180 (3d ed. 1991). This problem was identified at least as early as 1971, *see* BARUCH, *supra* note 342, at 55-56, but was not remedied in the SEC’s rulemaking following the passage of SIPA.

410. 17 C.F.R. § 240.15c3-3(b)(1) (1999).

411. *See, e.g.*, Bloomenthal & Salcito, *supra* note 348, at 168.

412. *See* Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, Exchange Act Release 34-9388 (Nov. 23, 1971), 36 Fed. Reg. 22,312, 22,313-14 (1971).

413. LOSS & SELIGMAN, *supra* note 409, at 3189-90.

414. *Id.* at 3160 n.112 (Rule 15c3-3), 3179 n.158 (section 8(b) and Rule 8c-1).

415. *See, e.g.*, Gotshall v. A.G. Edwards & Sons, Inc., 701 F. Supp. 675, 678 (N.D. Ill. 1988).

416. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1578 (9th Cir. 1990); Brannan v. Eisenstein, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); SEC v. Seaboard Corp., 677 F.2d 1301, 1313-14 (9th Cir. 1982); Kidder Peabody & Co. v. Unigestion Int’l, Ltd., 903 F. Supp. 479, 493-95 (S.D.N.Y. 1995); Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848, 857-58 (S.D.N.Y. 1995). Section 17 of the 1934 Act and its record keeping requirements also do not create a private cause of action. *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560, 571 (1979); *accord* Continental Bank, Nat’l Ass’n v. Village of Ludlow, 777 F. Supp. 92, 103 (D. Mass. 1991); FMC Corp. v. Boesky, 727 F. Supp. 1182, 1197 (N.D. Ill. 1989), *aff’d on other grounds*, 36 F.3d 255 (7th Cir. 1994); Deutsch v. Integrated Barter Int’l, Inc., 700 F. Supp. 194, 201 (S.D.N.Y. 1988).

cal evaluation of the SEC's and SROs' effectiveness in enforcing the various rules promulgated under section 15 becomes even more crucial in light of inability of private litigants to enforce these rules. Therefore, the lack of any serious study by the supporters of Revised Article 8 of such enforcement activities becomes even more problematic.

#### IX. SECURITIES INVESTOR PROTECTION ACT

This Article does not attempt an in-depth review and discussion of SIPA and the SIPC. Rather, it highlights a number of practical problems in the SIPC's administration of SIPA that proponents of Revised Article 8 have ignored. In addition, the interaction of Revised Article 8 and SIPA creates a number of legal issues that cast doubt on the continued effectiveness of insurance coverage.

The first practical problem is the size of the SIPC Fund, which is based on questionable assumptions. The preconception that the SIPC is a back-up to the SEC's regulatory regime<sup>417</sup> accounts for the SIPC's assumption that it will never have to liquidate more than one major broker-dealer<sup>418</sup> within a short period of time. In addition, the SIPC has assumed that any failed broker-dealer would have complied with the SEC's possession and control rules and that, therefore, there would be no shortfall in customer securities.<sup>419</sup> Based on these assumptions, the SIPC has set \$1 billion as its goal for the SIPC Fund.<sup>420</sup>

The assumption that only one large broker-dealer can fail at one time is based on a further assumption that there is no systemic risk involving broker-dealers. If the potential occurrence of the domino effect predicted by the systemic risk theory was real, then more than one large broker-dealer could fail at one time. The fact that the SIPC

417. *See supra* Part VIII.

418. *See* GAO 1992, *supra* note 348, at 44.

419. *See id.* at 45. On the other hand, the SIPC has made certain other, more conservative, assumptions, including "that the failed broker-dealer's capital would be depleted to the point that its required reserves would be exhausted and that the trustee would not recover any portion of the broker-dealer's partially secured and unsecured receivables." *Id.*

420. *See id.* at 44. In addition, the SIPC has a bank line of credit of \$1 billion, *see id.* at 19, and the ability to borrow an additional \$1 billion from the SEC, which in turn would borrow the funds from the Department of the Treasury, *see* 15 U.S.C. §§ 78ddd(g)(h) (1994). Although the SIPC has set the size of the SIPA Fund to accommodate the liquidation of a single major broker-dealer, the SIPC has made no special arrangement for liquidating such a broker-dealer. *See* GAO 1992, *supra* note 348, at 54. This lack of preparation is striking because, as of 1992, the largest SIPC liquidation had involved processing only 61,000 customer claims while, in 1990, there were over fifty securities firms with more than 100,000 customers accounts. *See id.* In addition, the SIPC is a minuscule agency with a mere twenty-nine staff members in 1996. *See* SIPC, 1996 ANNUAL REPORT 4. These are hardly the numbers needed for a major liquidation.

is overseen by the SEC,<sup>421</sup> one of the prime movers behind Revised Article 8 and presumably a subscriber to the systemic risk theory, lends a certain irony to the SIPC's position.

The GAO has criticized the second assumption behind the size of the SIPA Fund. "In view of the prevalence of fraud in past smaller SIPC liquidations, we believe that the possibility of fraud or of a serious breakdown of internal controls cannot be ruled out, even though SEC contends that these controls are monitored more closely in larger broker-dealers."<sup>422</sup>

The final practical problem with SIPA is the exclusion from its coverage of certain financial intermediaries that have access to customer funds and securities.<sup>423</sup> In raising this issue in its 1992 report, the GAO did not estimate the parameters of this issue (e.g., number of customers affected, typical size of securities holding, etc.), although it did note that, "in the last 5 years, 26 of 39 SIPC liquidations involved failures resulting from fraud on the part of introducing

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421. See 15 U.S.C. § 78ccc(e) (1994). In 1992, the GAO criticized the SEC for not paying "sufficient attention to its SIPC oversight responsibilities." GAO 1992, *supra* note 348, at 61.

422. GAO 1992, *supra* note 348, at 45. The uniform net capital rule finally adopted in 1975 was intended to both "enhance the protection of customer funds and securities held by broker-dealers . . . [and] to protect the SIPC fund by requiring all broker-dealers to operate under a sound capital base." Net Capital Rule: Proposed Uniform and Comprehensive Regulation, Exchange Act Release 34-9891 (Dec. 5, 1972), 38 Fed. Reg. 56 (1973). In 1982 the SEC significantly reduced the net capital requirements of broker-dealer using the Alternative Capital Method (ACM). See Net Capital Requirements for Brokers and Dealers; Amended Rules, Exchange Act Release No. 34-18417 (Jan. 13, 1982), 47 Fed. Reg. 3512 (1982). At the same time, haircuts (required discounts in calculating reserve capital) were increased on most debt securities and preferred stock. See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 34-18737 (May 13, 1982), 47 Fed. Reg. 21,759 (1982). In 1985, only a minority of broker-dealers used ACM, but this minority included most of the large broker-dealers. See SEC, THE FINANCING AND REGULATORY CAPITAL NEEDS OF THE SECURITIES INDUSTRY 60 ex. 13, 68 ex. 18 (1985). The net effect of the 1982 amendments was to reduce the required regulatory capital of broker-dealers by over \$550 million. See *id.* at 14. "By these amendments the Commission intended to give broker-dealers greater freedom to use capital where it can be most productive." *Id.*

423. See *id.* at 68-69. All persons registered with the SEC under section 15(b) of the 1934 Act are members of SIPC unless they fall into an excluded category. See 15 U.S.C. § 78ccc(a)(2)(1994). SIPC membership includes:

all persons registered as brokers or dealers under section 78o(b) of this title, *other than*

(i) persons whose principal business, in the determination of SIPC, taking into account business of affiliated entities, is conducted outside the United States and its territories and possessions; and

(ii) persons whose business as a broker or dealer consists exclusively of (I) the distribution of shares of registered open and investment companies or unit investment trusts, (II) the sale of variable annuities, (III) the business of insurance, or (IV) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts.

*Id.* (emphasis added).

firms that did not retain customer accounts.”<sup>424</sup> Although applicable state law may require government securities brokers or dealers to be SIPC members, federal law does not.<sup>425</sup> In a 1990 report, the GAO noted that most broker-dealers that deal in government securities are registered under section 15(b) of the 1934 Act and, therefore, are members of SIPC.<sup>426</sup> A small group of specialist dealers, some of which can hold customer funds and securities, are not SIPC members.<sup>427</sup> Finally, there is a group of bank dealers that are not SIPC members,<sup>428</sup> and that may hold customer cash and securities.<sup>429</sup> As with the 1992 report, the GAO in its 1990 report provided no estimates of the potential size of the risk represented by these specialist and bank dealers.

All that this Article means to suggest by the foregoing cursory review of SIPA and the practical operations of the SIPC is that the adequacy of the insurance coverage for investors whose securities and cash is held by financial intermediaries is unclear. Certainly, the GAO’s conclusion that “the regulatory framework within which SIPC operates has *thus far* been successful in protecting customers while at the same time limiting SIPC’s losses”<sup>430</sup> must be read as what it is, a statement of past history and not a prediction of the future.<sup>431</sup>

424. GAO 1992, *supra* note 348, at 69.

425. *See* Don & Wang, *supra* note 338, at 513 n.22.

426. *See* UNITED STATES GENERAL ACCOUNTING OFFICE, GAO/GGD-90-114, U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED 5, 25-26, 60-61 (1990). By July 1989, 1,496 diversified securities firms that were already registered with the SEC had updated their registration with the SEC “on a revised form that better described the firms’ government securities activities.” *Id.* at 25.

427. *See id.* at 60-61. In July 1989, this consisted of a total of sixty-three specialist firms, twenty of which could hold customer funds and securities. *See id.* at 26, 60.

428. *See id.* at 27. In July 1989, there were 281 registered bank dealers. *See id.* at 26.

429. *See id.* at 26 n.3. There is no FDIA coverage for shortfalls of securities although there may be insurance coverage under the FDIA for cash up to \$100,000 held by an insured bank. “Similarly, if a bank failed, securities held for a customer would be returned to that customer . . . . Bank customers would appear, however, to have less protection than under SIPC if a bank failed, a customer’s securities were missing, and the bank was liquidated rather than merged into another institution.” *Id.* at 62.

430. *Id.* at 3 (emphasis added).

431. *See* Rogers, *supra* note 7, at 1538 (quoting the GAO’s conclusion without any discussion of the GAO’s concerns); *see also* Mooney, *supra* note 114, at 313 (relying upon SIPA to argue that “[a]n upper-tier priority rule would neither pit the rich against the poor nor the large and sophisticated against the small and unsophisticated”). Professor Mooney also states that the private insurance maintained by “many securities firms” provides “additional protection to customers.” *Id.* at 313 n.8. In coming to this conclusion, he ignores the criticism of private insurance made by the GAO. *See* GAO 1992, *supra* note 348, at 51-52. As the GAO notes:

[h]istorical experience with private insurance plans, like the excess customer protection insurance coverage carried by many major broker-dealers, has shown that coverage frequently cannot be obtained when it is needed most. For example, private insurance coverage for customers with account values above

In addition, the defined term “customer” has been given a restricted reading by the courts in situations where the customers are trustees acting on behalf of numerous beneficiaries. This reading, in turn, deprives these customers of access to the SIPA Fund. In *SIPC v. Morgan, Kennedy & Co.*,<sup>432</sup> the Second Circuit held that the trustees of a profit-sharing plan constituted a single customer under SIPA.<sup>433</sup> Although there were 108 employee-beneficiaries of the plan, only one recovery by the trustees was allowed.<sup>434</sup> The effect of this holding was to give each employee-beneficiary an interest in a recovery limited to what a single customer could receive. The Second Circuit noted that an analogy to the Federal Deposit Insurance Act’s protection of customer accounts was inappropriate.<sup>435</sup> SIPA does treat

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SIPC coverage limits was not renewed at either Drexel or Thomson McKinnon before their closing.

*Id.*

432. 533 F.2d 1314 (2d Cir. 1976).

433. *See id.* at 1318 (“The financial relationship, insofar as the Plan is concerned, was entirely between the beneficiaries and their employer, *not* the broker-dealer.”).

434. *See id.* at 1321.

435. *See id.* at 1318 (“We cannot accept appellee’s analogy of the two statutes in the case at bar. SIPA and FDIA are independent statutory schemes. . . .”). As the Second Circuit noted, certain predecessor bills to SIPA had provided for a separate recovery by each beneficial owner of an account with an insolvent broker-dealer but these provisions had disappeared in the final, enacted bill. *See id.* at 1318 n.8. In fact, the first predecessor bills had explicitly provided that:

[SPIC] shall *not* be required to recognize as the owner of any portion of a customer account or insured liability appearing on the records of a closed insured broker or insured dealer under a name other than that of the claimant, any person whose name or interest as such owner is not disclosed on the records of such closed broker or dealer as part owner of said customer account or insured liability, *if* such recognition *would increase* the aggregate amount of the insured customer accounts or insured liability in such closed broker or dealer.

S. 2348, 91st Cong. § 7(d) (June 9, 1969); H.R. 13308, 91st Cong. § 7(d) (Aug. 4, 1969) (emphasis added). The subsequent Senate bills dropped this restriction, providing that each customer of a broker-dealer or bank that had an account with a debtor under SIPA would be considered a “separate customer” of the debtor if “the books and records of the debtor or . . . the books and records of” the broker-dealer or bank establish that the “claims of such broker or dealer or bank arise out of transactions for customers of such broker or dealer or bank.” S. 2348, 91st Cong. § 11(c) (Sept. 21, 1970); *accord* S. 2348, 91st Cong. § 2 (June 18, 1970) (proposing a new section 35(i)(8) to the 1934 Act); S. 3988, 91st Cong. § 2 (June 18, 1970) (proposing a new section 35(j) to the 1934 Act); S. 3989, 91st Cong. § 2 (June 18, 1970) (proposing a new section 35 (j)(8) to the 1934 Act).

Under FDIA, 12 U.S.C. §§ 1811 et. seq. (1997), in contrast, employee beneficiaries of a trust, similar to the trust in question in the *Morgan, Kennedy* case, would be treated as individual customers for purposes of determining the limit of insurance coverage. Section 1821(a)(1)(B) provides that the “net amount due to any depositor at an insured depository institution shall not exceed \$100,000 as determined in accordance with subparagraphs (C) and (D).” 12 U.S.C. § 1821(a)(1)(B) (1997). Subparagraph (D) states that coverage is provided on a “pro rata or ‘pass-through’ basis to a participant in or beneficiary of an employee benefit plan.” 12 U.S.C. § 1821(a)(1)(D) (1997). For a definition of an employee benefit plan, one has to look to section 1821(a)(8)(B)(ii), which provides that an “employee benefit plan” has the same meaning given to that term found in section 1002(3) of the Employment Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001 et. seq. (1988).

each customer of a “broker or dealer or bank” as a “separate customer of the debtor” when the “net equity claim” of the “broker or dealer or bank” arises “out of transactions for customers.”<sup>436</sup> But the failure to similarly protect beneficiaries of a trust is a glaring omission that cautions against placing too much reliance on quick analogies to FDIC insurance.

These practical and definitional concerns are exacerbated by the legal issues that Revised Article 8 raises with respect to SIPA. Although Professor Rogers attempts to separate discussion of Revised Article 8 from that of SIPA, Revised Article 8 has the potential of greatly weakening SIPA’s protection of individual customers. This weakening arises from the disparity between the conceptions of the property interest held by customers of broker-dealers underlying SIPA and Revised Article 8. Revised Article 8 is based on the concept that “in almost all cases when a customer holds her investment assets in an account at a securities intermediary, she will be deemed not to be the direct holder of such assets, but a holder of this new *sui generis* property right” created by Part 5 of Revised Article 8.<sup>437</sup> In contrast, SIPA is based on concepts of possession and constructive possession. In a liquidation, customers covered by SIPA receive preference over any creditors of the bankrupt SIPC member with respect to “customer name securities” and, more importantly, “customer property.” Customer name securities<sup>438</sup> correspond roughly to what Revised Article 8 defines as a “security,”<sup>439</sup> when that security has been registered to a customer. In the indirect holding system, few securities are customer name securities.

SIPA’s broader category of customer property covers “cash and securities (except customer name securities delivered to the customer)

Section 1821(a)(3) makes it clear that the “pass-through” basis described in 1821(a)(1)(D) insures “in an amount not to exceed \$100,000 *per participant* per insured depository institution.” 12 U.S.C. § 1821 (a)(3)(A) (1997) (emphasis added). Section 1821(a)(3)(B) supports this, stating that the “amount aggregated for insurance coverage . . . shall consist of the present vested and ascertainable interest of *each participant* under the plan.” 12 U.S.C. § 1821(a)(3)(b) (1997) (emphasis added).

Assuming that a plan is an employee benefit plan, FDIC insurance provides better protection for the beneficiaries of a trust deposited with a bank than SIPA provides for similarly situated beneficial owners of securities.

436. 15 U.S.C. § 78fff-3(a)(5) (1994).

437. Jeanne L. Schroeder, *Some Realism about Legal Surrealism*, 37 WM. & MARY L. REV. 455, 522 n.210 (1996).

438. The SIPA defines “customer name securities” as securities which were held for the account of a customer on the filing date by or on behalf of the debtor and which on the filing date were registered in the name of the customer, or were in the process of being so registered pursuant to instructions from the debtor, but does not include securities registered in the name of the customer which, by endorsement or otherwise, were in negotiable form.

15 U.S.C. § 78lll(3) (1994).

439. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-102(a)(15).



at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer.”<sup>440</sup> Under SIPA, the term “securities” is roughly congruent with the defined term “security”<sup>441</sup> in Revised Article 8.<sup>442</sup> This creates a definitional problem:<sup>443</sup> it is possible that a securities intermediary under Revised Article 8 may hold no “securities,” as such term is defined in SIPA. It may hold only security entitlements or a combination of securities and security entitlements. Such security entitlements, however, would presumably fall under the catch all provisions of SIPA’s definition of customer property: “any other property of the debtor which, upon compliance with applicable laws, rules, and regulations, would have been set aside or held for the benefit of customers.”<sup>444</sup> Assuming that “applicable laws” would be construed to include Revised Article 8, a securities intermediary could hold a security entitlement for customers, as required under SIPA, because the securities intermediary, under Revised Article 8, would be holding such security entitlement for entitlement holders “[t]o the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset . . . .”<sup>445</sup> This set aside applies to all interests in financial assets held by a securities intermediary, not just financial assets themselves, and, therefore, would cover a securities intermediary’s own security entitlements. Insofar as a court were to use Revised Article 8 to construe SIPA, either by applying the “applicable law” phrase of the catch all provision to the entire definition of cus-

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440. 15 U.S.C. § 78lll(4) (1994) (emphasis added). Proceeds of customer property, including proceeds derived from unlawful conversion, are also customer property. *See id.*

441. The term “security” is defined as

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, any collateral trust certificate, preorganization certificate or subscription, transferable share, voting trust certificate, certificate of deposit, certificate of deposit for a security, any investment contract or certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or mineral royalty or lease (if such investment contract or interest is the subject of a registration statement with the Commission pursuant to the provisions of the Securities Act of 1933 [15 U.S.C. § 77a et seq.]), any put, call, straddle, option, or privilege on any security, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase or sell any of the foregoing, and any other instrument commonly known as a security. Except as specifically provided above, the term “security” does not include any currency, or any commodity or related contract or futures contract, or any warrant or right to subscribe to or purchase or sell any of the foregoing.

15 U.S.C. § 78lll(14) (1994).

442. *See* 1994 OFFICIAL TEXT, *supra* note 2, § 8-102(a)(15).

443. This argument is an elaboration of one set forth by Professor Schroeder. *See* Schroeder, *supra* note 31, at 486-87.

444. 15 U.S.C. § 78lll(4)(D) (1994).

445. 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(a).

tomers property,<sup>446</sup> or by directly construing the phrase “at any time received, acquired, or held by or for the account of a debtor from or for the securities account of a customer” in the definition,<sup>447</sup> Revised Article 8 would dramatically change the meaning of customer property.

This change would arise from the exception for certain creditors of a securities intermediary that revised section 8-503 makes to the set aside for entitlement holders.<sup>448</sup> The exception is for creditors of a securities intermediary that have control over the pertinent financial asset<sup>449</sup> and for creditors of a clearing corporation that have a security interest in the pertinent financial asset.<sup>450</sup> Insofar as these two categories of creditors have a claim upon certain financial assets, these financial assets are no longer available to entitlement holders under Revised Article 8 and, presumably, no longer customer property under SIPA. The corpus of customer property under SIPA, therefore, can be diminished by unilateral action by a securities intermediary, even unilateral action that is in violation of its obligations under revised section 8-504<sup>451</sup> and the applicable SEC rules.<sup>452</sup>

Nor does a securities intermediary have to violate its obligations in order to pledge customer securities. Even a securities intermediary that is in compliance with revised section 8-504 and the applicable SEC rules may pledge customer securities to secure loans made to customers. The SEC’s segregation and hypothecation rules override revised section 8-504 insofar as revised section 8-504 requires a securities intermediary to “obtain and thereafter maintain a financial asset” and these requirements are the “subject” of SEC rules.<sup>453</sup> The SEC’s hypothecation rules allow free hypothecation of customer securities in amounts that do not exceed aggregate customer debt to

446. See Schroeder, *supra* note 31, at 486.

447. See, e.g., SEC v. Aberdeen Sec. Co., 480 F.2d 1121, 1127 (3d Cir. 1973) (holding that “local law” or applicable “regulations” should be used to determine meaning of the term “obligations” in section 6(g) of the 1970 version of SIPA).

448. Revised section 8-503(a) explicitly states that financial assets necessary to meet claims of entitlement holders “are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511.” 1994 OFFICIAL TEXT, *supra* note 2, § 8-503(a).

449. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-511(b). See *supra* Part VI.B.1. for a discussion of control creditors.

450. See 1994 OFFICIAL TEXT, *supra* note 2, § 8-511(c). See *supra* Part VI.C. for a discussion of secured creditors and clearing corporations.

451. Revised section 8-504 sets forth a securities intermediary’s obligation to “promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset.” 1994 OFFICIAL TEXT, *supra* note 2, § 8-504(a).

452. Schroeder, *supra* note 31, at 490.

453. 1994 OFFICIAL TEXT, *supra* note 2, §§ 8-504(a), 8-509(a). “If the substance of a duty imposed upon a securities intermediary by Sections 8-504 through 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty.” *Id.* § 8-509(a).

the broker-dealer,<sup>454</sup> while the segregation rules allow the hypothecation of margin securities other than excess margin securities. Setting aside the issue of how these two sets of rules coordinate,<sup>455</sup> the hypothecation rules allow considerable leeway to securities intermediaries in pledging their customers' securities.

The argument made by proponents of Revised Article 8, that the SIPC only has to cover shortfalls in securities holdings and, therefore, that the current \$500,000 insurance limit for each customer is more than adequate,<sup>456</sup> looks suspect when one realizes that the category of customer property has been severely restricted by Revised Article 8. Only if customer property is not materially depleted by the claims of control creditors of securities intermediaries or secured creditors of clearing corporations does the concern about the adequacy of SIPC coverage for individual investors disappear.<sup>457</sup>

A more farfetched concern is raised by Revised Article 8's reconceptualization of an entitlement holder's property interest in a security entitlement. Insofar as it could be plausibly argued that this property interest is now *only* a contractual right of the entitlement holder against his or her securities intermediary, the SIPC could argue, in a liquidation proceeding, that the entitlement holder is not eligible for protection under SIPA. Numerous cases under SIPA have held that the contractual or securities law claims of a customer of a SIPC member that is being liquidated do not, in and of themselves, give rise to claims under SIPA.<sup>458</sup> In coming to this conclusion, the

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454. See *supra* text accompanying notes 407-08.

455. See *supra* text accompanying notes 409-12.

456. See Rogers, *supra* note 7, at 1538 n.161.

457. Professor Guttman's point that SIPA coverage is inadequate to protect "many investors, especially professionals dependent on such investments as 'nest eggs' for their retirement," Guttman, *supra* note 201, at 18, remains a valid one, despite Professor Rogers' dismissal of it, see Rogers, *supra* note 7, at 1538 n.161.

458. See, e.g., *In re Stalvey & Assoc., Inc.*, 750 F.2d 464, 471 (5th Cir. 1985) (plaintiff's "customer status in the course of some dealings with a broker will not confer that status upon other dealings, no matter how intimately related, unless those other dealings also fall within the ambit of the statute"); *SEC v. S.J. Salmon & Co., Inc.*, 375 F. Supp. 867, 870 (S.D.N.Y. 1974) (rescission claim based on fraudulently induced securities purchases is not a "customer claim" under SIPA); *In re Oberweis Sec., Inc.*, 135 B.R. 842, 846 (Bankr. N.D. Ill. 1991) (a "failure to execute an order to buy securities . . . is not a customer claim protected by the SIPA") (citation omitted); *In re Bell & Beckwith*, 124 B.R. 35, 36 (Bankr. N.D. Ohio 1990) (fraudulent inducement to a purchase is not a "customer claim" even when plaintiff had another valid "customer claim"); *In re Gov't Sec. Corp.*, 90 B.R. 539, 542 (Bankr. S.D. Fla. 1988) (mark-up paid to broker-dealer for a securities purchase does not give rise to a claim under SIPA "whether it was paid unknowingly, or by reason of non-disclosure or by reason of actual fraud"); *In re MV Sec., Inc.*, 48 B.R. 156, 160-61 (Bankr. S.D.N.Y. 1985) (claim of fraud or overreaching is not a "customer claim"); *SEC v. Investment Sec. Corp.*, 2 Bankr. Ct. Dec. (CRR) 453, 454 (Bankr. E.D. Mo. 1976) ("Persons having claims for damages on account of breach of contract, or for damages arising out of tortious conduct where a trust fund or trust property is not created by that tortious conduct, are not customers within the meaning of [SIPA]."); *SEC v. Howard Lawrence & Co.*, 1 Bankr.

courts have relied upon both the requirements of the definition of “customer”<sup>459</sup> and upon the policies behind SIPA.<sup>460</sup> A “customer” under SIPA is a person “who has a claim on account of securities received, acquired or held by the debtor.”<sup>461</sup> In turn, a “security” is defined as a type of “instrument.”<sup>462</sup> Whatever securities entitlements are, they are not instruments. The policy arguments, which focus on who SIPA was meant to protect,<sup>463</sup> do not lend themselves so easily to a restrictive meaning for “customer.” Under either approach, the courts have shown, however, a great hesitancy in expanding SIPA coverage, even if a category of claimants meet the literal requirements of SIPA’s definition of “customer.”<sup>464</sup> The same issue of whether to take a liberal or conservative approach to the definition of “customer” also is reflected in cases involving repurchase agreement buyers who do not take possession of the underlying securities and whose counterparties are liquidated under SIPA.<sup>465</sup>

As with the 1934 Act’s segregation and hypothecation rules,<sup>466</sup> customers of broker-dealers have to depend upon the regulatory agencies to ensure that the SIPC carries out its statutory duties. Only the SEC has the right to obtain judicial review of “the refusal of SIPC to commit its funds or otherwise to act for the protection of customers of any member of SIPC.”<sup>467</sup> Customers do not have this right.<sup>468</sup> The lack of any study of the SIPA by supporters of Revised

Ct. Dec. (CCR) 577, 579 (Bankr. S.D.N.Y. 1975) (“The SIPA does not protect customer claims based on fraud or breach of contract.”).

459. See, e.g., *In re Stalvey & Assoc., Inc.*, 750 F.2d at 472.

460. See, e.g., *SEC v. S.J. Salmon & Co., Inc.*, 375 F. Supp. at 867.

461. 15 U.S.C. § 78lll(2) (1994).

462. *Id.* at § 78lll(14).

463. See *SEC v. F.O. Baroff Co.*, 497 F.2d 280, 283 (2d Cir. 1974) (indicating that Congress intended to protect only “public customer[s]” and “trading customers”); *SEC v. S.J. Salmon & Co.*, 375 F. Supp. at 871 (“The principal purpose of [SIPA] was to protect investors against financial losses arising from the insolvency of their brokers”).

464. See, e.g., *In re Stalvey & Assoc., Inc.*, 750 F.2d at 472 (“Judicial interpretations of ‘customer’ status support a narrow interpretation of the SIPA’s provisions.”).

465. See generally Jeanne L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 SYRACUSE L. REV. 999, 1037-42 (1996) (discussing case law involving broker-dealer liquidations under Chapter 7 and SIPA and repurchase agreements). The cases have split on whether such buyers are customers under SIPA. *Id.* at 1040-42.

466. See *supra* Part VIII.A.2.

467. 15 U.S.C. § 78ggg(b) (1994).

468. *SIPC v. Barbour*, 421 U.S. 412, 425 (1975). In holding that customers of SIPC members do not “have an implied private right of action under the Securities Investor Protection Act of 1970 . . . to compel the SIPC to exercise its statutory authority for their benefit,” *id.* at 413-14, the *Barbour* Court explained the policy behind its holding in the following way:

Except with respect to the solidest of houses, the mere filing of an action predicated upon allegations of financial insecurity might often prove fatal. Other customers could not be expected to leave their cash and securities on deposit, nor other brokers to initiate new transactions that the firm might not be able to cover when due if a receiver is appointed, nor would suppliers be likely to con-

Article 8 becomes more troubling given the procedural limitations on enforcement of what are already substantively problematic statutory provisions.

#### X. THE REVISION PROCESS LEADING TO REVISED ARTICLE 8

Professor Rogers refers a number of times to the generalist lawyers involved in the drafting process to answer any concern that Revised Article 8 is the creation of a small group of financial industry participants. This group of generalist lawyers is Professor Rogers' most powerful argument that individual investors' interests were thoroughly considered and were protected in the drafting process.<sup>469</sup>

Starting with the 1988 ABA report that was the progenitor of Revised Article 8, the process of revising 1977 Article 8 was dominated by representations of major corporate law firms, federal regulators of the securities and banking industries, and SROs in the securities industry. Of the seventeen members of the ABA's Advisory Committee on Settlement of Market Transaction, five were current or former partners of major American corporate law firms;<sup>470</sup> four came from

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tinue dealing with such a firm. These consequences are too grave, and when unnecessary, too inimical to the purposes of the Act, for the Court to impute to Congress an intent to grant to every member of the investing public control over their occurrence. On the contrary, they seem to be the very sorts of considerations that motivated Congress to put the SIPC in the hands of a public board of directors, responsible to an agency experienced in regulation of the securities markets.

*Id.* at 422-23 (footnotes omitted). The *Barbour* Court did leave open the issue of whether, under the Administrative Procedure Act, a determination by the SEC not to bring an action against the SIPC "might be reviewable . . . for an abuse of discretion." *Id.* at 425 n.7. There has been no case law that addresses this issue.

469. Rogers, *supra* note 7, at 1433, 1544-45. Professor Norman I. Silber criticizes this type of argument:

It does not suffice to assert that an interest has been adequately considered because of the inclusion of the personal sympathies of individuals with other distinctive formal roles and responsibilities—especially roles that require them to try to *separate* themselves from such sympathies . . . . In the securities case, the fact that some drafters had their own stock portfolios tells us little or nothing about whether they represented the interests of consumers.

Norman I. Silber, *Consumer Participation in the Law-Drafting Process: Past, Present, and Future*, 9 ADVANCING THE CONSUMER INTEREST 27, 28 (1997).

470. Robert Haydock, Jr., (Bingham, Dana & Gould), Stephen H. Case and Richard B. Smith (both Davis Polk & Wardwell), George P. Haley (Pillsbury Madison & Sutro), and Robert C. Mendelson (Morgan, Lewis & Bockius). Bingham, Dana & Gould represents Bank of Boston Corp. and Liberty Financial Cos. Ltd. See Margaret Cronin Fisk, *Skadden, Arps Leads in Financial Survey Again*, NAT'L L.J., June 17, 1996, at C2. Davis Polk & Wardwell counts among its most important clients J. P. Morgan & Co. Inc., Merrill Lynch & Co. Inc., Morgan Stanley, Dean Witter, Discover & Co., Aetna Inc., Donaldson, Lufkin & Jenrette, SunAmerica Inc., and The Chubb Corp. Pillsbury Madison & Sutro represents BankAmerica Corp., Wells Fargo & Co., Union Bancal Corp., Westamerica Bancorp., and Lincoln Nat'l Corp. And Morgan, Lewis & Bockius represents CoreStates Financial Corp., Merrill Lynch & Co. Inc., General Reinsurance Corp., and Charles Schwab Corp. See Margaret Cronin Fisk, *Who Represents Financial America; New York Megafirms Lead Financial Field*, NAT'L L. J., Oct. 13, 1997, at C3.

the counsel's offices of federal agencies;<sup>471</sup> three came from the counsel's offices of SROs;<sup>472</sup> and two were academics.<sup>473</sup>

The drafting committee for Revised Article 8 was more broadly representative of the legal community and contained practicing lawyers with a variety of backgrounds. Although they were not lawyers from *The American Lawyer's* listing of the 100 most important corporate law firms, as of 1997, they were members of regional law firms with not less than nine attorneys,<sup>474</sup> with the median being twenty-seven attorneys.<sup>475</sup> Judging by their current Martindale-Hubbell entries, although at least four were litigators, not one was a plaintiff's lawyer<sup>476</sup> or a consumer advocate. Three members of the drafting

471. Jonathan Kallman (SEC), Andrea M. Corcoran (Commodities Futures Trading Commission), Ernest T. (Federal Reserve Bank of New York), and Virginia Rutledge (Treasury Department).

472. Dennis Dutterer (Board of Trade Clearing Corp.), Richard G. Ketchum (NASD), and Richard B. Nesson (The Depository Trust Company).

473. Professor Egon Guttman (American University, Washington College of Law), and Professor Charles W. Mooney, Jr. (University of Pennsylvania School of Law). An early draft of Professor Mooney's influential article advocating a complete revision of 1977 Article 8, *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305 (1990), was published in October 1989 as part of a contractor report on clearance and settlement prepared by Bankers Trust Company for the Office of Technology Assessment. See 2 BANKERS TRUST COMPANY, *supra* note 70, at 157. Professor Mooney brought his own well thought out approach to the process of revising 1977 Article 8, one congruent enough to that of the federal regulators to be included in the Bankers Trust Company report.

474. K. King Burnett's firm, Webb, Burnett, Jackson, Cornbrooks, Wilber, Vorhis & Rouse, LLP, is the smallest firm with only nine attorneys. See 8 MARTINDALE-HUBBELL LAW DIRECTORY MD421B-422B (1997).

475. Richard Hite's firm, Kahrs, Nelson, Fanning, Hites, Kellogg, has twenty-four attorneys. See 7 MARTINDALE-HUBBELL LAW DIRECTORY KS141B-142B (1997). Justin Vigdor's firm, Boylan, Brown, Code, Fowler, Vigdor & Wilson, has thirty-three attorneys. See 11 MARTINDALE-HUBBELL LAW DIRECTORY NY483B-486B (1997). Howard Swibel's firm, Arnstein & Lehr, has ninety-eight attorneys. See 7 MARTINDALE-HUBBELL LAW DIRECTORY IL 88B-96B (1997). John Fox Arnold's firm, Lashly & Baer, has twenty-seven attorneys. See 10 MARTINDALE-HUBBELL LAW DIRECTORY MO337B-340B (1997). Of course, Davis, Polk & Wardwell, Richard B. Smith's firm, is the largest with 480 attorneys. See 12 MARTINDALE-HUBBELL LAW DIRECTORY NYC306B-316B (1997). These numbers do not reflect any inclusion of member Harold T. Rosen as he is not listed in any directory.

476. K. King Burnett listed himself as a Fellow, American College of Trial Lawyers, and one of his practice areas as litigation. See 8 MARTINDALE-HUBBELL LAW DIRECTORY MD421B (1997). Richard C. Hite was also a Fellow, American College of Trial Lawyers, in addition to being a member of the Kansas Association of Defense Council and practicing in the areas of civil trial and product liability. See 7 MARTINDALE-HUBBELL LAW DIRECTORY KS141B (1997). Howard J. Swibel practiced in, among other things, litigation. See 7 MARTINDALE-HUBBELL LAW DIRECTORY IL93B (1997). Finally, Justin L. Vigdor listed one of his practice areas as commercial litigation. See 11 MARTINDALE-HUBBELL LAW DIRECTORY NY484B (1997). The American College of Trial Lawyers is an exclusive association of roughly 5,000 of the top trial lawyers in the country. See William J. Dean, *Action by Administrative Board of the Courts*, N.Y. L.J., Nov. 7, 1997, at 3. Three of these attorneys also listed business or securities law as one of their practice areas: K. King Burnett, Howard J. Swibel, Justin L. Vigdor. Two more lawyers were evidently transactional business lawyers: John Fox Arnold (Member, National Association of Bond Lawyers) and Richard B. Smith (Davis Polk & Wardwell). Mr. Smith served as Commissioner, U.S. Securities and

committee were legal academics,<sup>477</sup> with Professor Rogers serving as the Reporter. The Review Committee for the Drafting Committee<sup>478</sup> consisted of one in-house counsel for a major university, one lawyer functioning as the president and chief executive officer of a major corporation, and a lawyer from a regional law firm.<sup>479</sup>

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Exchange Commission from 1967 through 1971. See 12 MARTINDALE-HUBBELL LAW DIRECTORY NYC307B (1997).

Although this Author has no basis on which to evaluate the contributions made by these attorneys to Revised Article 8, Professor Rubin's experience with revised Article 3 and 4 suggests that individuals with such backgrounds do not necessarily function as consumer surrogates. Although 35 of the usual 108 members of the ABA's subcommittee on the Articles 3 and 4 revisions were lawyers "[e]mployed by [c]orporate [u]sers" and only 25 were "[e]mployed by [b]anks and [o]ther [f]inancial [i]nstitutions," Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 748 n.17, the corporate user attorneys did not represent consumer interests. This role "fell largely to the law professors." *Id.* at 755 (citations omitted). Insofar as all of the corporate user attorneys have personal checking and other banking accounts, one would have expected them to function as consumer surrogates if Professor Rogers is correct that the "dedicated generalist lawyers" can substitute for consumer advocates. See Rogers, *supra* note 7, at 1544-45. Although Professor Rubin does not remark on the failure of the corporate user attorneys to represent consumer interests in the revision of Articles 3 and 4, many of the factors he discusses with respect to revised Articles 3 and 4 would apply with equal force to Revised Article 8. See Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 748-68. Professor Rubin described the various ways in which the bank attorneys on his subcommittee "tended to see the world from the perspective of their clients." *Id.* at 749. This point would have to be generalized to apply to the lawyers involved in the Article 8 Drafting Committee. Most of these lawyers did not represent the broker-dealers and commercial banks that will benefit directly from Revised Article 8. But they could all be expected to share the perspective that major institutions of American capitalism, such as leading broker-dealers and commercial banks and their federal regulatory agencies, are, in Professor Rubin's words, "reputable, well-run institutions." See *id.* at 749. There is no real need to be concerned about individual investors because the major institutions of American capitalism are already concerned about them.

477. See 1994 OFFICIAL TEXT, *supra* note 2. Robert E. Desiderio teaches commercial law, corporations, tax and other related business law courses at the University of New Mexico; Egon Guttman teaches commercial law, corporations, securities and other business law related courses at the American University, Washington School of Law; Curtis R. Reitz teaches commercial law, contracts and other related courses at the University of Pennsylvania School of Law; and Ann E. Conaway Stilson (formerly known as Ann E. Conaway Anker) teaches contracts, corporations, securities regulation, property and other business related courses at Widener University School of Law. See AMERICAN ASSOCIATION OF LAW SCHOOLS, THE AALS DIRECTORY OF LAW TEACHERS 1997-98 at 390, 514, 826, 939.

478. The Review Committee evaluates a draft completed by the Drafting Committee to improve the draft and determine if it is ready to submit to the entire Committee. In so doing, the Review Committee suggests any necessary changes in language in order to clearly communicate the policy considerations and improve general understanding. See HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE MEETING IN ITS NINETY-EIGHTH YEAR 411 (1994).

479. Gerald L. Bepko works for Indiana University. See 7 MARTINDALE-HUBBELL LAW DIRECTORY IN38P (1997). Michael P. Sullivan is President and Chief Executive Officer of Int'l Dairy Queen. See 10 MARTINDALE-HUBBELL LAW DIRECTORY MN82P (1997). Reed L. Martineau is at Snow, Christensen & Martineau in Salt Lake City, Utah. See 16 MARTINDALE-HUBBELL LAW DIRECTORY UT114B (1997).

480. Although Curtis R. Reitz has written extensively on legal issues involving the Uniform Commercial Code, his writings in law reviews have not focused on Article 8 concerns. See, e.g., Curtis R. Reitz, *Manufacturers' Warranties of Consumer Goods*, 75 WASH.

Not one member of the ABA's Advisory Committee or the Drafting Committee and its Review Committee was a consumer advocate and, except for Professor Guttman, the legal academics had not written on issues of securities settlement and clearance, much less addressed these issues from an individual investor perspective.<sup>480</sup> The individual investor was no better represented in the process of adoption in New York State. In New York, the major study of Revised Article 8 was conducted by the Association of the Bar of the City of New York, which established a joint subcommittee of the Committee on Uniform State Law and the Banking Law Committee dominated by members of major New York City corporate law firms.<sup>481</sup>

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U. L.Q. 357 (1997); Curtis R. Reitz, *Enforcement of the General Agreement on Tariffs and Trade*, 17 U. PA. J. INT'L ECON. L. 555 (1996); Curtis R. Reitz, *Introduction: International Economic Law*, 17 U. PA. J. INT'L ECON. L. 29 (1996); Curtis R. Reitz, *Construction Lenders' Liability to Contractors, Subcontractors and Materialmen*, 130 U. PA. L. REV. 416 (1982); Curtis R. Reitz & Michael L. Seabolt, *Warranties and Product Liability: Who Can Sue and Where?*, 46 TEMP. L.Q. 527 (1973).

In addition to his law review articles, Professor Reitz co-edited a commercial law casebook with John Honnold, see JOHN O. HONNOLD & CURTIS R. REITZ, *CASES, PROBLEMS AND MATERIALS ON SALES TRANSACTIONS: DOMESTIC AND INTERNATIONAL LAW* (1992), and wrote his own casebook, CURTIS R. REITZ, *CASES AND MATERIALS ON CONTRACTS AS BASIC COMMERCIAL LAW* (1975).

481. Of the ten members of this joint subcommittee, six came from such law firms: two from Cleary, Gottlieb, Steen & Hamilton (Sandra Rocks, a special counsel, see 12 MARTINDALE-HUBBELL LAW DIRECTORY NYC224B (1997), and Daniel Feit, an associate, see *id.*), two from Davis Polk & Wardwell (Margaret E. Tahyar, an associate, see *id.* at NYC 315B, and Randall D. Guynn, a partner see *id.* at NYC 312B), one from Sullivan & Cromwell (Erik D. Lindauer, a partner, see *id.* at NYC 1351B), and one from Simpson Thacher & Bartlett (John L. Walker, a partner, see *id.* at NYC 1276B). Cleary, Gottlieb, Steen & Hamilton represents Fleet Financial Group Inc., US Bancorp, Salomon Inc., American Express Co., General Reinsurance Corp., Greenpoint Financial Corp.; and Albank Financial Corp. Sullivan & Cromwell counts among its most important clients Bankers Trust New York Corp., The Bank of New York Co. Inc., Mellon Bank Corp., Comerica, Central Fidelity Banks, Inc., Riggs National Corp., American Int'l Group Inc., H. F. Anmanson & Co., Dime Bancorp Inc., and Bank Plus Corp. And Simpson Thacher & Bartlett represents The Chase Manhattan Corp., and Lehman Bros. Holdings Inc. See Fisk, *supra* note 470, at C2. Davis Polk & Wardwell's broker-dealer and commercial banking clients are described at *supra* note 470.

There was an SRO lawyer, Norman R. Nelson, the general counsel of the New York Clearing House Association. See 12 MARTINDALE-HUBBELL LAW DIRECTORY NYC289P (1997). The New York Clearing House Association is an organization responsible for processing electronic transfers for New York banks. Steven Marjanovic, *In Concession, Fed to Test Faster Settlements*, AM. BANKER, Jan. 28, 1998, at 1. For a general description of a clearing house and the settlements and transactions involved, see 8 MICHIE ON BANKS AND BANKING (A.D. Kowalsky et. al. eds.) Ch. 18 §§ 1, 2 (1988). Ms. Joseph was a legal academic at the time of the Article 8 Bar Report, and has published in the area of mediation. See Cassandra E. Joseph, *The Scope of Mediator Immunity: When Mediators Can Invoke Absolute Immunity*, 12 OHIO ST. J. ON DISP. RESOL. 629, 629 (1997). Two academics completed the committee: Professors Paul M. Shupack and James A. Fanto. In light of the dominant role played by Davis, Polk & Wardwell in the adoption process for Revised Article 8, it is interesting to note that Professor Fanto was a Davis, Polk & Wardwell associate from 1988-1993.

Professor Shupack has written a number of articles concerning the UCC, mostly focused on Article 9, as well as Articles 3 and 4, but not on securities law issues. See, e.g., Paul M.



The statement made by proponents of Revised Articles 8 that consumer groups were not excluded from the revision process does not necessarily mean that adequate steps were taken to incorporate them. Professor Rogers does not deny that individual investors were not represented in the revision process for Revised Article 8:

[A]lthough the Chair of the Revised Article 8 Drafting Committee wrote to a number of groups that represent the interests of individual investors at the *beginning* of the revision project, none of them judged the project to be of sufficient concern to their constituencies to come to drafting committee meetings or communicate any other comments.<sup>482</sup>

Professor Rogers' explanation for this lack of interest is that "presumably . . . consumer law advocates naturally devote their limited resources to matters that genuinely concern the groups or interests they represent"<sup>483</sup> and that no such matters existed in Revised Article 8. The explanation equally could be that Revised Article 8 and the clearance and settlement of securities are difficult subjects requiring a fair amount of expertise in order to evaluate, expertise that consumer groups do not normally possess.<sup>484</sup> In addition, the control creditor and collusion provisions of most concern to individual investors were not included in the drafts of Revised Article 8 until early

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Shupack, *Preferred Capital Structures and the Question of Filing*, 79 MINN. L. REV. 787 (1995); Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273 (1994) (appearing in a symposium on the revision of Article 9); Paul M. Shupack, *Cashier's Checks, Certified Checks, and True Cash Equivalence*, 6 CARDOZO L. REV. 467 (1985) (discussing UCC Articles 3 and 4).

In contrast, Professor Fanto's writings are focused on securities law but not issues involving commercial law or Article 8 of the UCC in particular. *See, e.g.*, James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119 (1996); James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investors*, 21 BROOK. J. INT'L L. 1 (1995); James A. Fanto, *Justice Blackmun and Securities Arbitration: McMahon Revisited*, 71 N.D. L. REV. 145 (1995). Finally, there were four members of the Committee on Uniform State Laws that contributed significantly to the Article 8 Bar Report: Margaret N. Kniffin, Karen S. Boxer, William T. Collins, III and Rick Antonoff. *See* ARTICLE 8 BAR REPORT, *supra* note 6, at 1 n.2. Messrs. Antonoff and Collins were lawyers with major New York City corporate firms, respectively Paul, Weiss, Rifkind, Wharton & Garrison, *see* 12 MARTINDALE-HUBBELL LAW DIRECTORY NYC 1004B (1997), and Thacher Proffitt & Ward, *see id.* at NYC 1577B. Ms. Boxer was the deputy general counsel of the Health & Hospitals Corp. *See id.* at NYC 62P.

482. Rogers, *supra* note 7, at 1545 n.166 (emphasis added). As Professor Rogers does not list any of these groups, it is impossible to evaluate their orientation and why they may not have responded to this invitation.

483. *Id.*

484. Professor Rogers hints at one reason for this lack of expertise when he writes that "Revised Article 8 is not the sort of legislation that raises . . . the sort of issues that are within the traditional province of consumer protection law." *Id.* That statement does not support, of course, the conclusion that individual investors should not be concerned by certain provisions of Revised Article 8.

1993<sup>485</sup> and the watering down of a securities intermediary's obligation to obtain securities to meet its obligation to its entitlement holders did not occur until spring 1994,<sup>486</sup> all subsequent, presumably, to the invitations extended to groups representing individual investors.

Professor Rubin describes the substantial funding and time constraints that restricted meaningful consumer participation in the revisions of Articles 3 and 4.<sup>487</sup> The only way to overcome such resource constraints would be to fund adequate legal representation for consumer groups. Although one can always argue about what is adequate, certainly more than the one overburdened consumer attorney described by Professor Rubin would be necessary. Each revision project should have a budget for consumer representation and the size of the budget and the extent and nature of the representation should be part of the discussion leading up to the undertaking of a revision. Certain revision projects, such as the one for letters of credit under Article 5, might be judged of minimal concern to consumers and, therefore, would require a low level of funding. Others, such as the one for Article 2, might require a higher level of funding.

In light of the significant resources devoted to Revised Article 8 by major American law firms and the significance of the collusion and control lender issues, significant resources should have been devoted to hiring representation for individual investors. At a minimum, a group should have been formed consisting of an experienced practicing lawyer, a legal academic and an economist. The two lawyers should have had, or been willing to develop, an expertise in commercial law, particularly issues of negotiability and security interests; and the economist should have had, or been willing to develop, an expertise in systemic risk in the financial markets. All three should have had practical or theoretical experience with the clearance and settlement of securities. In addition, there was a need for expertise in evaluating the federal regulatory regimes and SIPA, which might have required additional members for the individual investor group. Although the amount of work would have ebbed and flowed over a period of years, each member of such a group would have had to invest a significant portion of his or her working time on such a project. No reputational gain would have necessarily accrued to any member of the group representing individual investors. Only monetary com-

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485. See *infra* text accompanying notes 505-15.

486. See *infra* text accompanying notes 499-504.

487. Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 761-62. Gail Hillebrand of Consumers Union was invited to attend meetings of the ABA Ad Hoc Committee on Payment Systems. See *id.* at 761. She had no funding, however, and could "attend only those meetings held near her home in the San Francisco area." *Id.* In addition, she had responsibility for all UCC revisions as well as a number of other statutory requirements affecting consumers. See *id.* This is a load that would have strained Wonder Woman.

compensation would have secured the necessary level of expertise and involvement.<sup>488</sup>

Even such measures as this article advocates may not be sufficient to protect consumers. Financial institutions and other major businesses not only dominate the national uniform laws revisions process but also the process by which the revisions are adopted at the state level. When financial institutions have found their interests adversely affected by the UCC, they have lobbied vigorously on the state level and proposed nonuniform amendments. When the UCC was first adopted by NCCUSL and the ALI in 1951, New York spent ten years studying this new creation, holding hearings all over the state, commissioning a series of reports that remain essential back-

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488. The revision of Articles 2 and 9, which have historically been identified as articles of concern to consumers, have benefited from much more formal and informal input from consumer advocates than has Revised Article 8. In the Article 9 context, for example, a special task force was created to evaluate the "recommendations [of the Study Group appointed by the Permanent Editorial Board of the UCC] from the consumer-protection perspective and to identify additional consumer protection issues related to secured credit." PERMANENT EDITORIAL BOARD FOR THE U.C.C., PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ART. 9 REPORT 3 n.9 (Dec. 1992). With regard to Article 2, whether to incorporate special provisions to protect consumers (versus merchants) and the content of such provisions has been a matter of extensive commentary prior to adoption of the revision by the ALI and NCCUSL. See, e.g., Hillebrand, *The Uniform Commercial Code Drafting Process*, *supra* note 12; Yvonne W. Rosmarin, *Consumers-R-Us: A Reality in the U.C.C. Article 2 Revision Process*, 35 WM. & MARY L. REV. 1593 (1994); Edith Resnick Warkentine, *Article 2 Revisions: An Opportunity to Protect Consumers and "Merchant/Consumers" Through Default Provisions*, 30 J. MARSHALL L. REV. 39 (1996). The debate over the procedural and substantive issues as they effect consumers is ongoing. See e.g., Jean Braucher, *Forward: Consumer Protection and the Uniform Commercial Code*, 75 WASH. U. L.Q. 1 (1997).

In contrast, there was only a single dedicated issue of the *Cardozo Law Review* in 1990 that focused on the problems in 1962 and 1977 Articles 8 and proposed solutions. 12 CARDOZO L. REV. 1 (1990). The most influential article, see Mooney, *supra* note 114, did not even consider any issues relevant to individual investors, relying upon the protection afforded by SIPA to justify a focus on "the rights and claims of market participants who are not eligible for, or whose claims exceed, such protection rather than smaller, probably less sophisticated investors." *Id.* at 313 n.8, 380-81. Most subsequent publications concerning Revised Article 8 have been technical, continuing legal education publications that have taken the policy choices of Revised Article 8 for granted. See, e.g., SECTION OF BUSINESS LAW, ABA, COMMITTEE ON UNIFORM COMMERCIAL CODE, THE JOY OF INVESTMENT SECURITIES: REVISED ARTICLES 8 AND 9 OF THE UCC (Mar. 23, 1995); MASSACHUSETTS CONTINUING LEGAL EDUCATION, INVESTMENT SECURITIES—THE NEW UCC ARTICLE 8 (1994). A handful of articles have been concerned with policy involving individual investors. See Guttman, *supra* note 201; Egon Guttman, *Investment Securities Law: New Federal and State Developments and Their Effect on Article 8*, 24 UCC L.J. 307 (1992); Egon Guttman, *U.C.C. D.O.A.: Le Roi Est Mort, Vive Le Roi*, 26 LOY. L.A. L. REV. 625 (1993); Rogers, *supra* note 7; Schroeder, *supra* note 31; David A. Kessler, Note, *Investor Casualties in the War for Market Efficiency*, 9 ADMIN. L.J. AM. U. 1307 (1996) (a student of Professor Guttman). The few additional academic pieces that have appeared have not addressed the policy issues concerning individual investors raised by Revised Article 8. See Darmstadter, *supra* note 254; Douglas R. Heidenreich, *Article Eight—Article Eight?*, 22 WM. MITCHELL L. REV. 985 (1996); Robert D. Hillman, *Other People's Money: Problems in Attaching Securities Under Three Versions of U.C.C. Article 8*, 16 J. L. & COM. 89 (1996); Mark G. Lake & Henry Bregstein, *Fraudulent Pledge of Securities of Nonpublic Corporations: The Inadequacy of UCC Article 8*, 112 BANKING L.J. 958 (1995).

ground material on the UCC to this day<sup>489</sup> and suggesting a series of changes that were incorporated in the 1956 version of the UCC<sup>490</sup> and in the version of the UCC enacted in New York State in 1962.<sup>491</sup> All of this activity emanated from opposition by an in-house counsel of Chase National Bank.<sup>492</sup>

This same type of activity by major business enterprises occurred more recently in the revision of Article 4A, where the issue of how to treat fraudulent wire transfers generated a great deal of concern among members of the National Corporate Cash Managers Association (NCCMA). Corporate attorneys who were members of NCCMA in 1988 joined the ABA subcommittee considering Article 4A and threatened “to oppose adoption of the entire Article 4A in the legislatures of all fifty states.”<sup>493</sup> This threat led to the attorneys who represented banks agreeing to a compromise with the attorneys representing major corporations.<sup>494</sup>

Without involvement by consumer representatives in the revision process for uniform laws, we may expect the results to reflect the interests of the organized interest groups that participate in this process. Academic commentators have suggested various theories to explain this result. Professors Schwartz and Scott have applied “structured-induced equilibrium” theory to conclude that “interest groups have more power in [private legislatures] than in ordinary legislatures (when there is only one active group).”<sup>495</sup> Professor Patchel has used interest group theory to argue “that smaller groups are those most likely to form an effective coalition to advance their collective interests.”<sup>496</sup> Professor Rubin has focused on the inability of attorneys

489. For descriptions of the legislative history of the original UCC in New York State, see Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958) [hereinafter Braucher, *Legislative History*]; Robert Braucher, *The 1956 Revision of the Uniform Commercial Code*, 2 VILLANOVA L. REV. 3 (1956); Norman Penney, *New York Revisits the Code: Some Variations in the New York Enactment of the Uniform Commercial Code*, 62 COLUM. L. REV. 992 (1962).

490. Braucher, *Legislative History*, *supra* note 489, at 802-04.

491. Penney, *supra* note 489, at 992-94.

492. Patchel, *supra* note 11, at 105-06. The New York City bankers acted through their trade organization, the New York Clearing House Association, in advocating revisions to both the 1951 and 1956 versions of the UCC. Penney, *supra* note 489, at 992-94.

493. Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 764.

494. *Id.* at 764-65.

495. Schwartz & Scott, *supra* note 11, at 597, 632. For a more informal development and application of this approach, see Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783 (1994).

496. Patchel, *supra* note 11, at 127 (citation omitted). “Consumers’ is a broad category of individuals—almost as broad as the public itself.” *Id.* Professor Patchel contrasts “consumers” to “business interests,” which are much smaller groups. *See id.* Such a comparison is particularly apropos to Revised Article 8, when one bears in mind the fact that there are millions of individual investors in contrast to a few thousand broker-dealers and potential control lenders.

to “check at the door . . . their conceptual framework,”<sup>497</sup> which led attorneys representing banks in the Articles 3 and 4 revision process to instinctively view banks as “reputable, well-run institutions” and consumers as “tend[ing] to be careless, mistaken or dishonest.”<sup>498</sup> This world view combined with the “dominance of the common-law model” of legal thought to produce an approach to drafting these revisions focused on “moral judgment[s]” and indifferent to “empirical research.”<sup>499</sup> Professor Clayton P. Gillette has emphasized the differences between rent-seeking in a public and a private legislature in concluding that “there are reasons based in legislative theory to believe that consumer interests would systematically fare poorly in private legislatures.”<sup>500</sup>

The drafting history of Revised Article 8 shows the considerable influence that a cohesive interest group can have. The development of revised sections 8-504 and 8-511, two sections of Revised Article 8 that are crucial to individual investors, and the concept of collusion show the progressive watering down during the drafting process of protections granted to individual investors. As this Author did not participate in the drafting process, he cannot provide a full explanation for why this watering down occurred.<sup>501</sup> All he can do is analyze the results.

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497. Rubin, *Thinking Like a Lawyer*, *supra* note 13, at 749.

498. *Id.*

499. *Id.* at 768-70.

500. Gillette, *supra* note 18, at 197. He points out that law offices devoted to consumer interests have limited financial resources and consumer groups have few opportunities to offer rent to corporate attorneys and academics who populate private law-making committees as such groups “can do little to offer a client base to the former or publicity (in the form of outlets for scholarship or the venting of policy positions) to the latter.” *Id.* at 197-98 (footnote omitted). In addition, logrolling by consumer advocates is structurally difficult both between revision projects, because there are few repeat players, and within revision projects “[i]f the majority of a drafting group is already in agreement and that agreement stands in opposition to or is indifferent to consumer interests.” *Id.* at 198-99.

501. The ALI and NCCUSL archives maintained by the Biddle Law Library at the University of Pennsylvania School of Law currently contain some materials on the drafting of Revised Article 8 donated by Professors Fred H. Miller and Curtis Reitz. *See* Letter from Melissa Backes to Professor Facciolo (Feb. 23, 1998) (on file with author) [hereinafter Backes Letter]. In addition, Professor Miller at the University of Oklahoma College of Law, who is also Executive Director of NCCUSL, has a large quantity of unpublished letters and memoranda concerning the revision process leading up to Revised Article 8 in his possession. *See* Letter from Fred Miller to Jay Facciolo (Jan. 20, 1998) (on file with author) [hereinafter Miller Letter of Jan. 20]. Eventually these materials will be donated to the ALI and NCCUSL archives. *See* Letter from Fred Miller to Francis Facciolo (Dec. 16, 1997) (on file with author). The amount of material in Professor Miller’s possession greatly exceeds that deposited at the Biddle Law Library. *Compare* Backes Letter, *supra*, with Miller Letter, *supra*. There must also be considerable additional quantities of unpublished material in the possession of other members of the Drafting Committee for Revised Article 8 and other interested parties that are not yet on deposit with the Biddle Law Library.

At this time, this Author could not obtain access to the materials in Professor Miller’s possession without allowing Professor Miller to set forth his views in footnotes in this article. *See* Letter from Fred Miller to Jay Facciolo (via electronic mail) (Feb. 9, 1998) (on file

Revised Section 8-504 provides a qualified obligation of a securities intermediary to “promptly obtain and thereafter maintain” sufficient “financial asset[s]” to satisfy all “security entitlements” of its “entitlement holders”.<sup>502</sup> This obligation is met by the “exercise[ ] [of] due care in accordance with reasonable commercial standards” even if the securities intermediary does not have the requisite financial assets.<sup>503</sup> The only exception to this obligation contemplated by the initial draft of the predecessor to revised section 8-504 was for the physical loss or destruction of a security.<sup>504</sup> Even this exception disappeared in a subsequent draft.<sup>505</sup> This approach continued in the drafts for about one year.<sup>506</sup> In April 1994, revised section 8-504 took substantially its present form.<sup>507</sup> Why revised section 8-504 moved from an unqualified obligation to obtain the necessary financial assets to one where “reasonable commercial standards” met this obligation is not explained in any of the drafts or in other publicly available materials. Whatever the subjective reasons for this change, it is one that objectively favors securities intermediaries over individual investors.

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with author). For examples of this approach in action, see *Uniform State Laws: A Discussion Focused on Revision of the Uniform Commercial Code*, 22 OKLA. CITY U. L. REV. 257, 278 n.10, 281 n.14 (1997) (contrasting the views of Professors Albert J. Rosenthal, the moderator for the discussion, and Miller).

This Author plans to write further on the revision process leading to Revised Article 8 when and if the Biddle Law Library has on file a sufficiently extensive set of unpublished materials to properly flesh out the outline of the story told by the drafts. In this connection, this Author encourages the various participants in the drafting process to forward all materials in their possession to the archives.

502. 1994 OFFICIAL TEXT, *supra* note 2, § 8-504(a).

503. *Id.* § 8-504(c)(2). See the discussion at *supra* text accompanying notes 449-50 for a discussion of revised section 8-504.

504. See Uniform Commercial Code Revised Article 8, § 8-502(a), Investments Securities (with Conforming Amendments to Article 9) with Prefatory Note and Comments (Oct. 6, 1992 Draft) [hereinafter Proposed Article 8 Oct. 1992 Draft]. In the February 16, 1993, draft the predecessor section to revised section 8-504 was redrafted to move the exception for the securities intermediary’s obligations into a new proposed section 8-510. See UCC Revised Article 8, § 8-510, Investment Securities With Comments (Feb. 16, 1993 Draft) [hereinafter Proposed Article 8 Feb. 1993 Draft]. The exception continued, however, to cover only physical loss and destruction. *Id.* § 8-510 cmt.

505. Uniform Commercial Code Revised Article 8, § 8-504, Securities and Securities Entitlements (with Conforming and Miscellaneous Amendments to Articles 1 and 9) with Prefatory Note and Comments (Apr. 1, 1993 Draft) [hereinafter Proposed Article 8 Apr. 1993 Draft]. Section 8-510 had disappeared from this draft and no similar provision had replaced it.

506. See, e.g., Uniform Commercial Code Revised Article 8, § 8-504, Investment Securities (with Conforming and Miscellaneous Amendments to Articles 1 and 9) (July 30-Aug. 6, 1993 Draft) [hereinafter Proposed Article 8 Summer 1993 Draft]; UCC Revised Article 8, Investment Securities With Prefatory Note and Comments (Jan. 1994 Draft), § 8-504 [hereinafter Proposed Article 8 Jan. 1994 Draft].

507. Uniform Commercial Code Revised Article 8, Investment Securities, § 8-504 (with Amendments to Article 9, Secured Transactions) (Proposed Final Draft, April 5, 1994) [hereinafter Proposed Article 8 Apr. 1994 Draft].

The drafting history of revised section 8-511 is another tale of a crucial statutory provision being changed to favor financial institutions, in this case securities intermediaries and control lenders, over individual investors. As with revised section 8-504, the drafts of Revised Article 8 are the only materials with which to examine this process. By the third draft in May 1992, the predecessor section to revised section 8-511 provided that the claim of a "secured party" that had "control" was to be satisfied before the claims of "account holders."<sup>508</sup> By October 1992, the predecessor section to revised section 8-511 no longer favored secured parties, providing instead that all "financial assets and securities" of a financial intermediary were to be "divided pro rata among all account holders."<sup>509</sup> By January 1993 there were two competing versions of what was to become revised section 8-511. One, favored by Professor Rogers, stayed, without qualification, with the pro rata distribution scheme to entitlement holders and the other provided that "a secured party has priority over claims of the securities intermediary's entitlement holders if: (1) the secured party has control over the security or securities entitlement; or (2) the entitlement holders' claims are for securities carried in a margin account."<sup>510</sup> This latter alternative is, of course, a direct predecessor of revised section 8-511(b). A month later, only one provision modeled on the latter alternative remained.<sup>511</sup>

The history of the development of collusion concept in the drafts of Revised Article 8 is perhaps the most disheartening story from the individual investor's perspective. Collusion was first introduced as a means of protecting a securities intermediary against claims by an entitlement holder that the securities intermediary had executed an improper order with respect to the entitlement holder's account.<sup>512</sup> In contrast, a transferee of a securities entitlement "acquire[d] the securities entitlement free of any adverse claim" if it was acquired "(1) for value, (2) in good faith; [sic] and (3) without notice of any adverse claim."<sup>513</sup> This standard of transferee liability is the section 8-302(1)(c) standard contained in 1977 Article 8, refined to reflect more clearly the operation of the indirect holding system.

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508. Uniform Commercial Code Revised Article 8, § 8-509(d), Investment Securities (May 1, 1992) [hereinafter Proposed Article 8 May 1992 Draft].

509. Proposed Article 8 Oct. 1992 Draft, *supra* note 504, § 8-510.

510. UCC Revised Article 8, Investment Securities, § 8-512(b) (with Conforming and Miscellaneous Amendments to Articles 1 and 9) without Prefatory Note and Comments (Jan. 4, 1993 Draft) [hereinafter Proposed Article 8 Jan. 1993 Draft].

511. Proposed Article 8 Feb. 1993 Draft, *supra* note 504, § 8-513.

512. See Proposed Article 8 Jan. 1993 Draft, *supra* note 510, § 8-510(a)(2).

513. *Id.* § 8-509(a). "Subsection (a) also applie[d] to a secured party who has obtained control over a securities entitlement pursuant to Section 9-116." *Id.* at 8-509(b). Early drafts used the defined term "securities entitlement" rather than the final "security entitlement."

The next draft in February 1993 generalized the collusion standard, applying it to transferees as well as to securities intermediaries.<sup>514</sup> The November 1993 draft<sup>515</sup> bifurcated transferees, treating transferees from securities intermediaries and from entitlement holders differently. Notice became the standard for a “purchase of a securities entitlement” from an entitlement holder,<sup>516</sup> while collusion became the standard for a “purchase from the securities intermediary of investment property.”<sup>517</sup> This bifurcation carried through to the final version of Revised Article 8<sup>518</sup> and does provide a modicum of comfort to individual investors. But in the indirect holding system, a securities intermediary is the most likely transferor of a financial asset; therefore, the standard that applies to a securities intermediary is the most significant one.

There is no consideration in the drafts of whether different policies for transferees as compared to those for securities intermediaries should lead to two different standards. In discussing securities intermediaries, Professor Rogers pointed out that they were agents or bailees and that many legal rules “protect agents and bailees from liability as innocent converters.”<sup>519</sup> Professor Rogers’ explanation for these legal rules is that a securities intermediary is “obligated by its contract to act on the instructions of” the entitlement holder and that “it seems unfair to put the [securities intermediary] in a position where it acts at its peril in complying with its contractual obligations”<sup>520</sup> when the securities intermediary only had “notice or knowledge that another person asserts a claim to the securities.”<sup>521</sup> What unfairness there would be in subjecting transferees to this risk is not explained. In fact, Professor Rogers distinguishes between an innocent agent or bailee that would not be liable for conversion and the “recipient of the property,” that could be so liable.<sup>522</sup>

514. Proposed Article 8 Feb. 1993 Draft, *supra* note 504, § 8-511.

515. UCC Article 8, ALI Council Draft No. 2 (Nov. 24, 1993) [hereinafter Proposed Article 8 Nov. 1993 Draft].

516. *Id.* § 8-510(c).

517. *Id.* § 8-512(a)(1).

518. See 1994 OFFICIAL TEXT, *supra* note 2, §§ 8-502, 8-503(e), 8-510(a) (final versions of proposed draft sections 8-510(c) and 8-512(a)(1) of Proposed Article 8 Nov. 1993 draft). The Official Comments attempt to resolve the evident contradiction between the notice language of revised section 8-502 and the collusion language of revised section 8-503(a) in favor of collusion. See *supra* text accompanying notes 231-34.

519. *Id.* § 8-310 rptr. note 2. Draft section 8-310 is relevant because the draft Official Comments state that draft “section [8-512] implements for the indirect holding system the same protections against conversion liability that Revised Section 8-310 provides to brokers, securities intermediaries, or other agents for bailees who deal with securities held directly by their customers. The basic policy rationale is discussed in the Reporter’s Note to that Section.” *Id.* § 8-512 rptr. note 2.

520. *Id.* § 8-310 rptr. note 2.

521. *Id.* § 8-310 rptr. note 4.

522. *Id.* § 8-310 rptr. note 2.



There is nothing in the drafts of Revised Article 8 that explains why the collusion standard was generalized in this fashion. In a memorandum to the Council of the ALI, Professor Rogers provides the following justification for this generalization:

The collusion standard here is used for reasons similar to the rationale for the rules on conduits and transfer agents. The function of intermediaries is to transfer securities on behalf of their customers. Rules imposing a risk of liability on parties dealing with the intermediary would impair their willingness to deal with intermediaries, and hence impair the interests of investors in having their intermediaries perform their central function.<sup>523</sup>

Fairness is not the policy that unites protecting all transferees of securities intermediaries and protecting securities intermediaries from being caught between an order from an entitlement holder and an adverse claimant. Rather, finality and the protection of securities intermediaries under all possible circumstances are the policies that unite the use of collusion in these two factually distinct situations.

The final version of Revised Article 8 has a single section protecting a securities intermediary transferring a financial asset in either the direct or the indirect holding system from any liability to “a person having an adverse claim to the financial asset” except if the securities intermediary has been enjoined from so transferring or if the securities intermediary “acted in collusion with the wrongdoer in violating the rights of the adverse claimant.”<sup>524</sup> In addition, an entitlement holder may not bring an action “with respect to a particular financial asset . . . , whether framed in conversion, replevin, constructive trust, equitable lien, or other theory” against a purchaser “who gives value, obtains control, and does not act in collusion with the securities intermediary” that transfers the financial asset.<sup>525</sup> As this Article discusses in Part VI.A.2,<sup>526</sup> collusion is a standard that severely undermines protections formerly available to individual investors.

In explaining why representatives of individual investors were not involved in the drafting Revised Article 8, it may not be irrelevant that the provisions that disfavored individual investors did not appear in the earliest drafts of Revised Article 8. Any individual investor advocate reviewing, for example, the ABA Report that provided the impetus for the Article 8 revision process would have found nothing that presaged revised sections 8-504 or the collusion standard

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523. Memorandum from James S. Rogers, Reporter, Drafting Committee to Revise the UCC Article 8, to the Council of the American Law Institute Memorandum (Nov. 22, 1993) (on file with author).

524. 1994 OFFICIAL TEXT, *supra* note 2, § 8-115.

525. *Id.* § 8-503(e).

526. See *supra* text accompanying notes 211-42.

that renders control lenders functionally immune from challenge, although there was a full discussion of the priorities issue to which revised section 8-511(b) is addressed.<sup>527</sup> Even the resolution of this priorities issue in favor of secured parties did not appear in the first two drafts of Revised Article 8, only appearing in the May 1, 1992 draft and disappearing in the October 6, 1992 draft.

The history of Revised Article 8's adoption in New York State also illustrates how a small, well-organized interest group consisting of attorneys that represent financial institutions can triumph over the relatively disorganized advocates for individual investors. In New York, the primary pre-enactment study of Revised Article 8 was done by a joint subcommittee of the Association of the Bar of the City of New York.<sup>528</sup> The Association's Committee on Consumer Affairs "reviewed" the report and had "no objection to its release by the Association," in part because "the Report provides guidance regarding the operation of Sections 8-503 through 8-508, particularly with respect to the collusion standard . . . , which should diminish potential difficulties for individual investors."<sup>529</sup> The initial bill introduced in New York had a preamble that defined collusion in a manner consistent with the *Article 8 Bar Report*. The final bill, a year later, had a considerably narrower gloss on collusion in its preamble.<sup>530</sup> Any initial gains made by the Committee on Consumer Affairs on the collusion issue were largely lost in the enacted legislation. The advocates of the individual investor had been neatly out-maneuvered by the advocates of the financial institutions.<sup>531</sup> As an empirical matter, this result can hardly be surprising. As a matter of policy, this result suggests that more structured measures of the type advocated by this Article to encourage consumer involvement in the revision process of uniform laws are necessary.

## XI. CONCLUSION

Revised Article 8 represents a major revision of the law governing securities transfers. It is an elegant piece of work, one that shows the hand of a master draftsman. And it is based on a powerful reconcep-

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527. *1991 ABA Report*, *supra* note 5, at 4, 35-40. Even this discussion of priorities assumed that bona fide purchaser rules would be in place and that "bona fide purchasers should prevail over non-bona fide purchasers." *Id.* at 36. The concept of collusion in Revised Article 8 has obviated bona fide purchaser concepts and in practice has put control lenders in an unchallengeable position. See *supra* text accompanying notes 216-21 for a discussion of this point.

528. See ARTICLE 8 BAR REPORT, *supra* note 6.

529. *Id.* at 1 n.2.

530. See *supra* text accompanying notes 2-6 for a discussion of these two different bills.

531. The current debate over the proper meaning of control, which is described *supra* in the text accompanying notes 248-52, is another example of financial institutions taking a second bite at an apple to gain the maximum advantage for themselves.

tualization of the appropriate means of describing the ways in which securities are held, providing the first comprehensive statutory treatment of the indirect holding system. This combination of elegance and intellectual insight is a heady brew. One is tempted to suspend one's critical faculties, especially in the face of statements that "Article 8 is one of the more recondite branches of commercial law."<sup>532</sup>

Professor Rogers' argument that Revised Article 8 reflects significant input from individual investors is unconvincing. The almost random input of generalist lawyers does not substitute for the consistent input of lawyers who represent individual investors and who are well versed in the many areas of expertise necessary to evaluate Revised Article 8.

Insofar as Revised Article 8 rests on unproven assumptions about systemic risk, the very real changes to the bona fide purchaser rules of 1977 Article 8 should give us pause. In the direct holding system, the protection afforded beneficial owners against bad actors has been significantly weakened. In the indirect holding system, the protection afforded a beneficial owner against bad actors is essentially meaningless. The only meaningful protection is the priority established by revised section 8-511(a) for entitlement holders. But a growth of control lending, which may be likely in the immediate future, combined with the proposed amendment to the Official Comments control definition,<sup>533</sup> would mean that the protections of revised section 8-511(a) also would be illusory, at least with respect to control creditors.

Two possible types of amendments to Revised Article 8 could provide appropriate protections for individual investors. The first would be to restore meaningful restrictions on bad action by protected purchasers and favored purchasers by returning to the bona fide purchaser concepts contained in 1977 Article 8.<sup>534</sup> Two problems would arise from this approach. First, a number of amendments to Revised Article 8 would be required and the ability to maintain uniformity might be negatively affected. Second, and more importantly, the inability under Revised Article 8 for courts to use tracing arguments would render these amendments largely nugatory. More effective,

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532. Rogers, *supra* note 7, at 1432.

533. See *supra* text accompanying notes 278-81 for a discussion of this point.

534. The Consumer Affairs Committee of the Association of the Bar of the City of New York initially considered a similar approach in the deliberations leading up to the final Article 8 Bar Report. RECOMMENDATION OF THE CONSUMER AFFAIRS COMMITTEE REGARDING THE ABCNY TASK FORCE REPORT RECOMMENDING ADOPTION IN NEW YORK OF REVISED ARTICLE 8 OF THE UNIFORM COMMERCIAL CODE 2-6 (Nov. 20, 1995 draft). The Consumer Affairs Committee considered proposing leaving the collusion standard of revised section 8-503(e) in place for institutional investors but replacing it with a notice standard of "an adverse claim" for natural persons with less than \$1 million in a securities account. *Id.* at 6-7 (emphasis added).

and more in keeping with the concepts underlying Revised Article 8, would be to directly address the control lender provisions of revised section 8-511(b) by limiting its operation or by deleting it in its entirety.

The most limited version of this second type of amendment would be to create an individual investor carve-out to revised section 8-511(b).<sup>535</sup> Such a carve-out would provide that control lenders would have priority over entitlement holders except for entitlement holders who had a claim on financial assets of less than a specified amount through their securities entitlements and/or who have total assets or individual income of less than a stated amount.<sup>536</sup> Those entitlement holders with claims above this line would be presumed to be sophisticated enough, either individually or through the quality of the advice they could afford, to evaluate the risks of participating in the indirect holding system.

Any such sophistication distinction ignores, however, the fact that all investors in securities, sophisticated and unsophisticated, as a practical matter have to participate in the indirect holding system. In addition, most financial advisors believe that investments in equities are an essential part of any investment strategy that seeks returns consistently higher than inflation. Finally, no other investment opportunities in America offer the liquidity and ease of entry of America's securities markets. Investment strategies that omitted securities entirely would have to focus on such illiquid and normally ex-

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535. This idea first surfaced in conversations with Professor Margaret N. Kniffin. Similar ideas are being explored in connection with the current revision of Article 9. There is a debate concerning whether restrictions should be placed on the assets that secured creditors can encumber under Article 9. Professor Elizabeth Warren has proposed a set aside for unsecured judgment lien creditors of "up to 20 percent of the value of a debtor's assets without regard to outstanding security interests." Elizabeth Warren, *Article 9 Set Aside for Unsecured Creditors*, UCC BULL., Oct. 1996, at 1. See generally James J. White, *The Slippery Slope to Bankruptcy: Should Some Claimants Get a "Carve-Out" from Secured Credit? No: It's a Populist Craving for a Petit Bourgeois Valhalla*, BUS. LAW TODAY, Jan./Feb. 1998, at 33; William J. Woodward, Jr., *The Slippery Slope to Bankruptcy: Should Some Claimants Get a "Carve-out" from Secured Credit? Yes: Reserve a Cushion of Free Assets for Unsecured Creditors*, BUS. LAW TODAY, Jan./Feb. 1998, at 32 (both discussing Professor Warren's proposal). Professor Warren's proposal as it now is drafted, even if adopted, would not help individual investors under Revised Article 8. Her proposal involves amending section 9-301, Warren, *supra*, at 3, while investment property such as securities and securities accounts is governed by revised section 9-115.

536. One possible source for these standards could be the definition of accredited investor in Regulation D under the 1934 Act. See 17 C.F.R. § 230.501(a) (1998). With respect to many entities, Rule 501(a) under Regulation D uses "total assets in excess of \$5,000,000" in its definition of an "accredited investor." *Id.* at §§ 230.501(a)(1), (3), (7). With respect to natural persons, Rule 501(a) uses (i) "net worth" in excess of \$1,000,000 or (ii) "individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years" and "a reasonable expectation of reaching the same income level in the current year" in its definition of an "accredited investor." *Id.* at §§230.501(a)(5), (6).

pensive investments as real estate or on such low earning vehicles as certificates of deposit.

The above argues for deleting revised section 8-511(b) in its entirety. Otherwise, investors will face a Hobson's choice: investing in securities through participation in the indirect holding system and running the risk of bad action by any one of a number of securities intermediaries that can lead to a shortfall in the pertinent financial assets; or investing by, metaphorically, putting money under their mattresses and risking low rates of return.

No legislative body, including the United States Congress, has undertaken the necessary empirical research to establish the existence of the systemic risks that Revised Article 8 is intended to alleviate.<sup>537</sup> In New York, the total legislative hearings on Revised Article 8 consisted of a single afternoon roundtable of approximately two hours on May 31, 1996, convened by Assemblywoman Helene Weinstein. Approximately twenty academics, practicing lawyers and securities industry personnel discussed Revised Article 8 for about three hours.<sup>538</sup> One clear example of the reliance on higher authority created by this lack of inquiry is the *Article 8 Bar Report*:

The judgment calls that form the basis for Revised Article 8's fundamental structure depend, in significant part, on predicting how legal rules affect the behavior of participants in the securities market. Our committee does not have the capacity to find out facts that would answer those on which the drafters of Article 8 relied. Without those facts, our committee ought to be asking the question of whether, *within the frame of its assumptions*, Article 8 does a good job.<sup>539</sup>

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537. See *supra* text accompanying notes 260-63 for a discussion of this point.

538. This Author was one of the participants. Even this limited roundtable is more effort than many states devote to considering new revisions of the UCC. Professor Steven L. Schwarcz, for example, reports:

Donald Rapson . . . and Neil Cohen, a professor of commercial law at Brooklyn Law School and the reporter for the Restatement of Guarantees and Suretyship, told the Author that Professor Cohen was teaching a course in Article 9 when a student asked whether New Jersey had adopted the 1972 amendments. Cohen replied that it had not. The student called his father, a senior member of the New Jersey legislature, and asked why the 1972 amendments had not been adopted. The father then asked the legislature's drafting office to present the amendments to his committee for possible legislative adoption, and Rapson was asked to testify in support of the amendments at a legislative hearing. When Rapson arrived, he was directed to read verbatim the amendments for the record, starting with the definitions section. Droning on while the committee enacted other business, he had not even completed the definitions before he was thanked, asked to stop, and informed that the amendments would be adopted without modification.

See Schwarcz, *supra* note 11, at 981 n.253.

539. Shupack Memorandum, *supra* note 62, at 8 (emphasis added).

Although this Author does not believe that the study of Revised Article 8 needed to extend over a ten-year period such as the one devoted to the original UCC from 1952 to 1962, a substantial commitment of resources and period of study should have been devoted to it other than the self serving efforts of the financial community's lawyers and the efforts of a handful of unself-interested participants such as Professor Rogers. Congress has left the area of securities transfers, an area that is traditionally one of state law, to the states and it remains to the states to balance the competing interests of investors and control creditors. As the states in turn have abdicated their traditional role by not fully examining Revised Article 8, we are left relying on the policy arguments of the supporters of Revised Article 8. As the factual grounding of these arguments has not been tested either by a rigorous legislative process or by substantial academic work, we are relying on the judgment of these supporters without any independent means of checking the factual predicates. Ultimately, we are hoping that father knows best.