

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 3 – PROPERTY INTERESTS IN INVESTMENT SECURITIES

Report on research into the 1994 revisions to Article 8 of the Uniform Commercial Code

Background paper to FMLC paper entitled, “Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute”

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1. INTRODUCTION

The Project on which the FMLC Working Group that has produced this paper was commissioned to work was "to draft proposals for an investment securities statute, to explore and progress options for legislation, to explain and promote the project both in the UK and internationally, and to consult with industry, the public sector and academia". As part of this, particular attention was paid to the law of the United States, as being the country which currently has the most fully developed, market-responsive set of rules governing investment securities. The United States commercial law of securities transfer and securities holding may be found in Article 8 of the Uniform Commercial Code ("**Article 8**"). Kirsty Devonport, a solicitor at Clifford Chance in London, was assigned by her firm to assist the FMLC Working Group by researching the US position from an English law perspective. Kirsty's primary role was to examine Article 8 and the relevant parts of Article 9 (the secured transactions provisions) in detail, to discuss with experts how well this is working in practice, to obtain clarification on key issues and to consider to what extent the UK practice and commercial requirements differ from that of the US. Overall, what lessons could be learnt from the Uniform Commercial Code and the revisions to Article 8 carried out in 1994?

The FMLC is grateful to the following persons who participated in and contributed to the research:

Professor James Rogers, Boston College Law School, Reporter to the Drafting Committee responsible for the 1994 revision of Article 8;
Professor Curtis Reitz, University of Pennsylvania, Chair of the Drafting Committee responsible for the 1994 revision of Article 8;
Sandra Rocks, Cleary, Gottlieb, Steen & Hamilton;
Randall Guynn, Davis Polk & Wardwell;
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Professor Egon Guttman, American University Washington College of Law.

The purpose of this report is to describe the genesis, content and aim of the 1994 Article 8 revisions from a particular perspective. This perspective is that of a foreign legal system aiming to design a law which works alongside the US

system without friction, matches the realities of the modern wholesale financial markets and changes only those parts of existing English law that really need it.

2. SUMMARY OF ARTICLE 8

The following is a short summary of the way in which the US Uniform Commercial Code provides for the rights arising where one person (the "**Client**") holds securities with a custodian (bank, broker, settlement system, etc) (the "**Intermediary**").

The Uniform Commercial Code ("**UCC**") is a model law for the United States of America which was designed in the 1940's to (i) simplify, clarify and modernize the law governing commercial transactions; (ii) permit the continued expansion of commercial practices through custom, usage and agreement of the parties; and (iii) to make uniform the law among the various jurisdictions. Article 8 is dedicated to "investment securities".

Article 8 was drafted on the assumption that securities were held and transferred in paper form, therefore it was updated in 1990 to provide for the transfer and holding of dematerialised securities. The 1994 version of the UCC incorporated revisions to reflect the widespread use of intermediaries, and was further revised to produce the 2002 form following a revision of the secured transactions rules.

The approach in the current form of Article 8 of the UCC is to state specific rules for certain aspects of the relationship of Intermediaries and Clients rather than relying on "inference from a categorisation of the relationship based on legal concepts of a different era".¹ In summary:

- A Client holding securities with an Intermediary has a bundle of rights in respect of the assets held by the Intermediary which are together referred to as a "security entitlement".
- A security entitlement exists where the Intermediary credits (or should credit) the account it maintains for the Client with the relevant "financial asset" and agrees that the Client is entitled to exercise the rights which comprise the financial asset held by the Intermediary (thus distinguishing the arrangement from, for example, a deposit of cash, an outright transfer, or a security arrangement).
- The securities held by the Intermediary are the "financial asset" (this may take the form of legal title to the securities (e.g. if the Intermediary's name is on the register of title) or a security entitlement held by the Intermediary through a third party).

¹ Prefatory Note to the 1994 Revision to Article 8, page 22.

- A Client acquires a security entitlement when the relevant financial asset is credited (or should have been credited) to its account with the Intermediary.
- A security representing other securities does not create a security entitlement (therefore instruments such as depository receipts or units in a fund will not create a security entitlement for the holder of the instrument, although the holder of course has its rights the holder of the instrument).
- An action based on an adverse claim to a financial asset cannot be asserted against the Client holding the security entitlement if the Client acquired the security entitlement for value and without notice of the adverse claim.
- Where an adverse claim to a financial asset is based on an assertion that the claimant's intermediary disposed of the financial asset in breach of its duties, that adverse claim cannot be asserted against the Client holding the security entitlement if the Client acquired the security entitlement for value and did not act in "collusion" with the claimant's Intermediary.
- The Intermediary is required to maintain a sufficient quantity of financial assets to satisfy claims of all Clients holding security entitlements.
- The holder of a security entitlement has a pro rata property interest in all interests in the relevant financial assets held by the Intermediary.
- The financial assets held by the Intermediary for its Clients are not the property of the Intermediary, and are not subject to claims from the Intermediary's general creditors.
- A security interest over a security entitlement is perfected by "control" either by transfer of the security entitlement, or by arranging that the Intermediary will act on instructions from the secured party to dispose of the security entitlement upon enforcement of the rights under the security interest.
- A secured party who has control takes priority over a secured party without such control, and where two or more secured parties have control, priority will depend on the time at which control was granted.

3. **THE EVOLUTION OF ARTICLE 8**

There is a well voiced concern in the wholesale financial markets about systemic risk and the ability of the clearing and settlement systems for securities trading to process the ever increasing volume and complexity of transactions in the modern securities markets.

Traditionally, the principal mechanism for the settlement of securities transactions was the physical delivery of certificates that represented the securities. The 1960s saw an increase in securities trading to such a level that the systems could not cope with the processing of the quantities of paper required to clear and settle the amount of trades happening each day and trading hours had to be curtailed because of the mounting backlog of unsettled transactions. It is said that at the time of the "paperwork crunch", the trading volume of the New York Stock Exchange was in the range of 10 million shares per day.

The response of the market to the paperwork crunch was to rely increasingly on the book entry system based on immobilisation as a means of transfer and settlement. This is to say that the market circumvents the need for the cumbersome delivery of physical certificates back and forth amongst market participants by depositing securities with a common depository. The issuer's records show the depository as the owner of the outstanding securities. The depository's records identify its participants' interests in those securities and the books of those participants reveal the interests of their customers. For most of the securities in the US indirect holding system, physical certificates do still exist. These certificates hardly ever move. Similarly, changes to the issuer's register of shareholders are rarely made. In this "indirect holding system", transfers are settled by adjustments to the accounts of the depository or another intermediary in the chain of the holding system. As such, the need for an adequate modern legal structure of commercial law rules concerning the system of securities holding through intermediaries became increasingly important.

The legislative response to the "paperwork crunch" was a revision of Article 8 in 1978 to provide parallel rules for uncertificated securities equivalent to the existing provisions of Article 8 that dealt with securities evidenced by paper certificates. This envisaged a move towards dematerialisation. Dematerialisation implies the issuance of securities under terms whereby investors are not entitled, or at least not usually entitled, to any paper certificates. Ownership (even without taking into account the effect of the indirect holding system) is established by entries on a register rather than proprietary rights in any physical instrument. It was, however, essentially still a direct securities holding system in which the investor, whether it held a certificate or not, had a direct relationship with the issuer. It still assumed that changes in ownership would take place by either the delivery of physical certificates or by the registration of transfer on the books of

the issuer. This did not match up with the market's response which was, as has been described above, to rely increasingly on the indirect holding system and settlements effected by entries in the accounts of intermediaries. This difference, and the resulting uncertainty of the application of the rules, was highlighted by the problems experienced in the market in the late 1980s and early 1990s.

4. **THE PROBLEM FACING THE US IN THE LATE 1980'S/EARLY 1990'S**

During the stock market break in October 1987, financial institutions were encouraged by the Federal Reserve Bank to help enhance liquidity in the market, in an effort to control and limit the risks of the disturbances by providing credit on a secured basis. However, when those institutions consulted their advisors to confirm the perfection arrangements for security interests in securities held through financial intermediaries, they were met with the startling response "that is a very interesting question".

In February 1990, further pressure was put on the system by the failure of the investment bank Drexel Burnham Lambert.

The issues facing the wholesale financial markets hosted by the UK are, of course, different. The essential concern, however, is lack of certainty in relation to financial collateral. The European Financial Collateral Directive addresses only some of the issues. We explain in the Project Overview the exact justification for the UK law reform to which the research described in this report is intended to contribute.

5. **THE PROCESS BY WHICH THE US ADDRESSED THE PROBLEM**

Various studies were carried out after the 1987 stock market break in which questions were raised about the impact of the application of the commercial law rules found in Article 8 to the system of holding securities through intermediaries. Although in 1987 Article 8 did contain provisions that applied to the indirect holding of securities, they had been bolted on to the traditional paper-based system of rules and were unhelpfully hidden within the provisions. Not only were the relevant provisions hard to find but it is reported that it was also difficult to be confident about their interpretation, especially when dealing with a multi tiered system of intermediaries.

The various studies and reports that analysed the events of October 1987 suggested that these uncertainties might have adversely affected the willingness of financial institutions to provide essential financing to the securities firms during this time of market disturbances.

In response to these reports, the two sponsoring bodies of the UCC; the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American Law Institute ("ALI"), established a Drafting Committee in the Spring

of 1991 to proceed as quickly as possible with the work of revising Article 8 to meet the needs identified by the studies.

The Drafting Committee was made up of members of the NCCUSL and of the ALI who were, broadly speaking, generalist lawyers that drew upon the assistance of a body of expert advisers. It is hailed as a revision that involved the cooperative efforts of a large number of governmental and non-governmental bodies that have interests in and responsibilities for different aspects of both securities markets and the general process of private law revision.

Securities holding systems can be extremely complex. It seems fair to say that the generalist lawyer has little understanding of the various relationships and mechanics that operate within the market. Professor Rogers, Reporter to the Article 8 1994 revision Drafting Committee, recalls how at the outset of the Article 8 revision "one could probably have counted on one hand - with a few fingers unused - the number of people among those appointed to the Article 8 Drafting Committee, or among the full membership of the sponsoring organisations that would ultimately have to approve the work of the Drafting Committee, who had any familiarity with either old [1978 version] Article 8 or the modern securities holding system".²

There is much to be said in favour of a revision of such a specialist area of law which is carried out by generalist lawyers. Such a process requires the subject to be broken down, made more digestible and more readily understandable by the ultimate user of the provision - the judge before whom a dispute about issues arising under the law is brought. Such accessibility is necessary for the certainty of application which is required for a dependable and efficient operation of the modern securities system.

The United States Congress had itself considered various legislative packages for amendments to the federal securities laws in the aftermath of the October 1987 stock market break and the failure of Drexel Burnham. It adopted the Market Reform Act of 1990 which included a provision authorising the Securities Exchange Commission (the "SEC") to promulgate federal regulations that would pre-empt state law on the transfer and pledge of securities if the SEC found that the absence of a uniform federal rule substantially impeded the safe and efficient operation of the national system for clearance and settlement of securities transactions.

It is reported that the SEC followed the 1994 revision closely, having concluded that if the situation could be addressed within the existing commercial state law

² "Toward International Harmonization of the Commercial Law of the Modern Securities Holding and Transfer System: Some Reflections from the United States Article 8 Revision Project", James Steven Rogers, responding comment to "Modernizing Securities Ownership, Transfer and Pledging Laws" IBA Business Law Section CMF Discussion Paper on the need for international harmonization, Randall D Guynn 1996 pages 59-65 at p.64

framework, that would be preferable to new federal pre-emptive authority. However, the SEC did retain the authority to pre-empt state law and to keep the area under review for a period of 10 years.

6. **ARTICLE 8**

6.1 An Overview

Interviewees identified five main features in Article 8:

- (1) It recognised the indirect holding system as exactly that;
- (2) It created a new legal concept for the rights, both property and contractual, that an investor acquires in that system;
- (3) It enhanced finality for dispositions effected by book entry, both by security interests and normal sales;
- (4) It recognised the efficiency of the right of re-use, where agreed upon by the parties³; and
- (5) It continued a long American tradition of permitting self-help - access to collateral without judicial intervention.³

The official commentary to the 1994 revision of Article 8 says "in a nutshell, the approach [was] to describe the core package of rights of a person who holds a security through a securities intermediary and then give that package of rights a name".

This approach may sound very radical. However, it is said that it did not change peoples' practices, nor was it perceived to change the outcome in any particular scenario beyond providing clarity. Nevertheless it was considered prudent in the revision process to disassociate the concept of the indirect holding system, and the rights of an investor in that system, from any other existing legal tradition by creating a new concept - the "security entitlement". This was done to reduce the possibility that other existing legal concepts and traditions might be applied by analogy to this distinct technical area which could have inappropriate or damaging results.

Professor Rogers views the main thing to highlight as the achievement of legal recognition for market delivery otherwise than by transfer. Once a position is booked (that is to say a credit is made to an account), the account holder has a security entitlement. There is no need to question where the interest came from. In today's market, where assets are fungible and deliveries are typically performed on a net basis, this provides clarity and is both cost and time efficient.

³ This was available both before and after the 1994 revision.

Article 8 establishes that the records of an intermediary who maintains securities accounts are not merely evidence of ownership of securities by that intermediary's customers but rather that these records constitute the entitlement or the right of ownership.

In essence, what an investor holds, when it holds through an intermediary, is a package of rights against, and duties and obligations of, its intermediary. In the Article 8 revisions, this package is given a name: a "security entitlement".

Article 8 protects the security entitlement holder who takes for value and without notice, or without acting in collusion with a wrongdoing intermediary, from all competing property claims of third parties who do not have a security entitlement in respect of the same financial asset and against the same intermediary as that investor ("like security entitlements"). Articles 8 and 9 then provide rules for dealing with priorities amongst those that do have like security entitlements and interests therein.

Having determined that an entitlement holder has a package of rights against its intermediary rather than that the customer is the owner of the property and the intermediary merely a bailee, the system needs to distinguish this claim from the claim of any and all creditors. Article 8 protects security entitlement holders against the claims of the general creditors of the intermediary.

6.2 Key concepts

Scope: When looking at the scope of Article 8, there appeared provisionally to be two aspects to consider; the entities and the assets to which the rules should apply.

Entities: Looking first to the entities to which the provisions apply. Article 8 dictates that a person acquires a security entitlement if a "securities intermediary" credits or is obliged to credit that person's securities account⁴. Securities intermediary is defined as a Clearing Corporation or "a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity"⁵. The application, therefore, is not limited to regulated brokers but rather will apply to anyone who, as part of its business, maintains securities accounts for others.

It was noted that the definition does not anticipate holding financial assets on one's own behalf. No reason could be identified for this distinction between house and client arrangements.

⁴ Article 8-501(b).

⁵ Article 8-102(a)(14)(ii).

Products: Turning then to the products to which the rules apply, there are three different product labels used in Articles 8 and 9: securities, financial assets and investment property.

The term "securities" is used in the context of the direct holding rules (parts 2, 3 and 4 of Article 8). The term "financial asset" includes "securities" but is wider and applies in the context of the indirect holding system (part 5 of Article 8). However, both "security" and "financial asset" expressly exclude commodity contracts.⁶ The term "investment property" is used in Article 9 and applies to the secured transactions rules. "Investment property" includes financial assets and also includes commodities futures.

The reason for the use of these different terms is that, with respect to the direct holding system, there was an established body of rules that people were comfortable with. Whilst there was an appetite to expand the concept of a "security" to some extent, there was no desire to make it all encompassing. The term "financial asset" is wider and opens the gates to a host of products that may be eligible for deposit and which may be brought into the clearing system. It does not, however, extend to commodity contracts.

In the revision of Article 8, both the SEC and the Commodities Futures Trading Commission ("CFTC") were involved. The SEC recognised that there were problems that needed to be fixed. The CFTC, however, remained more ambiguous and resisted any interference with the commercial relationship between the commodities futures merchant and the commodities futures buyer. However, the CFTC did welcome the secured transaction rules. For this reason, the term "investment property" was used to apply the provisions of Article 9 to financial assets and to commodities futures.

The "Securities Account": It became clear that the scope of the indirect holding system rules was not to be determined by either the entities or the products but rather that the critical element was the "securities account". The essence of the securities account is that the securities intermediary that maintains the account agrees to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset. The nature of the relationship is, therefore, the key. This structure seems to provide comfort that certain common investment media and arrangements, which would be adversely affected by any application of the indirect holding provisions, are excluded from the regime without the need to meticulously exclude such investments product by product (e.g. the common trust and the bank deposit).

If the application of the rules depends upon the relationship being one in which the intermediary undertakes to treat the account holder as entitled to exercise the

⁶ Article 8-103(f)

rights that comprise that financial asset, then the ability to contract out of the provisions had to be explored. A certain level of confusion exists in this area and about the extent of intermediaries' obligations under the part 5 rules.

Contracting Out: Under Article 8, the ability to contract out of the obligations of the intermediary that comprise the security entitlement is limited by an overall duty of good faith. It was suggested that if parties agree to contract out of the Article 8 provisions to any considerable extent, then the relationship would no longer fit within the definition of a securities account, and as such would no longer be within the scope of the indirect holding system.

Some concern was expressed about any system that openly invites parties to contract out of the indirect holding system scheme of rules. It was, however, overwhelmingly recognised that flexibility within the rules was required. In practice, it seemed that this issue was simply one that had not been tested.

"Security entitlement": A security entitlement is the rights and property interests of a person who holds securities or other financial assets through a securities intermediary.⁷ It is a package of personal rights against the holder's security intermediary and an interest in the property held by that intermediary. It is not, however, a property interest in any specific financial asset held by the securities intermediary or traceable through to the assets held by the clearing corporation through which the securities intermediary holds the financial asset.⁸ The definition in Article 8-102 of a security entitlement cross refers to the rules of Part 5 of Article 8. As such, "the entirety of Part 5 [which sets out the rights against, and the obligations of, a securities intermediary] is the definition of security entitlement."⁹

Each security entitlement is individual and distinct; it is the "rights and property interests of a person ("A") who holds ... financial assets through a securities intermediary". If A then sells its rights and property interests in the financial assets it holds through its intermediary to B, what B acquires is a new securities entitlement and not the transfer of A's security entitlement. B's rights and property interests in the assets are personal to B, they are a new set of rights and property interests regardless of whether or not B's intermediary is the same institution as that through which A held the assets. Strictly speaking, therefore, a security entitlement is never "purchased" or "sold" but rather is "acquired" or "extinguished".

"Control": Article 8 contains a recurring concept that lies at the heart of two issues central to the indirect holding system that will be discussed below. This

⁷ Article 8-102(17)

⁸ Article 8-104(c) and Article 8-503

⁹ Official comments to Article 8-102(17)

concept is that of "control". During the Article 8 revision process, it was recognised that a plethora of collateral arrangements exists in the market, from the outright transfer of collateral to the agreement to pledge. It was noted that it is sometimes impossible for third parties to distinguish between a purchase and a security interest by way of outright transfer (in particular in the repo markets). Therefore, a line was drawn in the continuum of arrangements at the point when the creditor has done enough to ensure that it can have the collateral sold off without any further action by the debtor. This is the concept of "control" and it requires the agreement of the debtor's intermediary. Within this concept, there is a range of agreements that a creditor can enter into depending on its assessment of the risk that it is willing to take. For example, the creditor might permit no changes in the collateral assets. Alternatively, active management might be allowed and restrictions may be imposed on the type of assets that the debtor may invest in, or controls may be imposed on the overall value of the portfolio. In addition, if the collateral is critical to the decision to lend, the creditor may always require an outright transfer of the collateral.

Account Finality: Article 8 is a system that favours account finality. Once an account is credited (or should by law have been credited) the account holder has a security entitlement regardless of whether or not the intermediary has obtained the corresponding financial asset. The credit is in essence the thing from which the rights against, and obligations of, the intermediary to the investor flow.

Adverse Claim Cut Off Rules: An extension of the principle of account finality is the "protected acquirer" rule. Any person who qualifies as a protected acquirer is protected against any claim that it is a violation of a third party's property interest in a financial asset for that person to hold, transfer or deal with the financial asset.

As has been discussed above, a security entitlement is a claim against an account holder's own intermediary and, to the extent that there may be a shortfall in a particular financial asset, may not be met in full in the intermediary's insolvency. As such, it is not possible to describe a person who acquires a security entitlement as a bona fide purchaser who takes free from all claims. The term "adverse claim" in Article 8 relates to the violation of a third party's property rights in a financial asset.¹⁰ This carves out the claims of common account holders whose property rights are not violated by other customers holding accounts with the same intermediary.

Article 8, part 5 contains three distinct "protected acquirer" rules. Article 8 allows for the fact that it may be difficult to distinguish between the buyer and the secured lender in an outright transfer arrangement by relying on the concept of "control" to determine the threshold for protection. In addition to control, if the adverse claim is a generic claim that a third party's property rights have been

¹⁰ Article 8-102(a)(1)

violated, the "acquirer" will only be protected if it had no knowledge of the adverse claim. This is embodied in both the general "protected acquirer" rule¹¹ and also in the rule applicable to those whose rights are derivative from the rights of another person who is and continues to be the entitlement holder (e.g. the Hold in Custody repurchase buyer)¹². If the adverse claim is that the third party's intermediary acted wrongly and as a result the "acquirer's" holding, transferring or dealing with the financial asset is a violation of the third party's property rights in that asset, there is a third provision that states that the "acquirer" will only be protected against that claim if it has control and did not act in collusion with the wrongdoing intermediary.¹³

The rationale behind this distinction is the fear that, with hindsight, it may be difficult for someone who "acquired" a security entitlement to prove that it did not have knowledge that a securities intermediary was acting wrongfully and concern about what level, and what kind of knowledge would be required before a person should not deal with a securities intermediary. After all, the mere fact that a securities intermediary sold customers' securities should not, of itself, cause any concern since such sale may, in many cases, accord with client instructions.

Collateral Arrangements: Articles 8 and 9 provide for flexibility of lending arrangements. As already discussed, it was appreciated during the revision of Article 8 that a wide variety of lending arrangements exists and the revision sought to recognise and to accommodate this variety.

Under Article 9, a security interest can be perfected by control, by filing. If the debtor is a broker, securities intermediary or commodities intermediary, a security interest enjoys automatic perfection.

"Perfection" simply means that the security interest would be good in the insolvency of the debtor, it does not mean that the security interest will have priority over competing claims, including a later security interest. Whether or not a security interest is enforceable against third parties will depend upon the priority rules.

Priority Rules: Where the concept of "control" once more plays a crucial role is in the determination of priorities. A security interest that is perfected by filing or by attachment is not protected against all competing property interests (i.e. the secured creditor is not a "protected purchaser") and will be subject to the priority of a security interest that is perfected by control.

¹¹ Article 8-502

¹² Article 8-510

¹³ Article 8-503(e)

A security entitlement holder has priority over the general creditors of its intermediary but not over a secured creditor who has control.

It is easiest to explain the priority and adverse claim cut off rules by reference to six priority situations: the mischievous intermediary, the bad faith purchaser, the double dealing intermediary, a shortfall in the intermediary's securities, the creditor versus account holders and the "upper tier attachment". These are best explained through the diagrams set out at Schedule 1 to this paper.

7. **LESSONS FROM AMERICA**

Article 8 cannot be read in a vacuum. There is a host of Federal regulatory provisions that back up the system. In addition, insolvency intervention is also an issue.

Article 8 is a property law and nothing else. It does not deal with the contract of sale or transfer, nor the custody agreement, and it is not regulatory. There was a resistance in the drafting of the 1994 revision to creating any type of parallel regulatory structure.

In defining the scope of the provisions, the crucial element is the definition of the "securities account" and depends upon the relationship between the securities intermediary and the investor. It was made clear in the meetings in the US that one should not get too concerned by the definitions of "securities" or "financial assets", which are intended to be wide and to cater for market evolution.

The "securities account" is more than mere evidence of ownership and in itself creates the entitlement to the rights and obligations that make up the indirect holding of securities.

Article 8 does not favour either the indirect holding system or the direct holding system. It simply makes provisions for both systems.

Article 8 is not free from concerns or criticisms but amongst those experts that were interviewed, these appeared to be more in the details than with respect to the overall structure. This was surmised by the comment of one interviewee that it is an innovative and workable piece of legislation that is internally very consistent. It is recognised that it is a difficult piece of legislation (conceptually) but it was said that it makes the market more efficient and workable. Any weaknesses were expressed as more apparent than real given the merits of strong operational integrity.

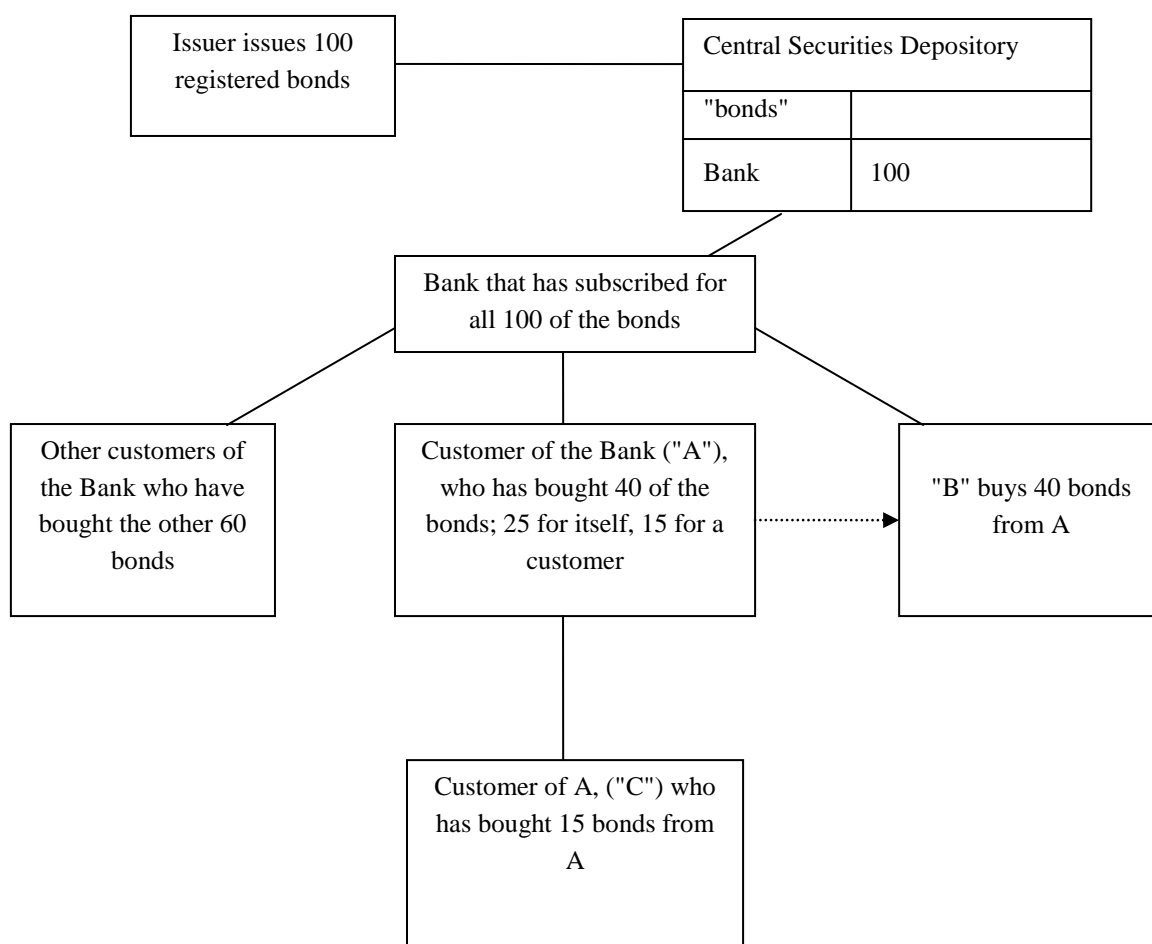
Article 8 is overtly practical. The drafters identified how the market worked, and described what they had found in legal terms. They did not try to impose any new legal or operational reality. Thus, in Article 8, a "securities account" is a type of relationship, not a way of recording information and a "security

entitlement" is a package of rights and obligations not a sui generis property right as such. This approach involved making an attempt to capitalise on underlying legal concepts of ownership, in particular the difference between the legal estate and the beneficial interest. However, Article 8 is not couched in the vocabulary of equity and trust law. Indeed, where - as is permitted - parties "contract out" of Article 8 by entering into an agreement that does not fall within the definition of a "securities account", it is mainly the rules of equity which determine the issues that Article 8 would otherwise address. The significance of these remarks for English Law is that they reveal a choice for the legislator between codifying equity (and perhaps making small modifications) and allocating a wholly new vocabulary to the indirect holding system of the securities markets.

Schedule 1: The Six Classic Priority Scenarios

In the following scenarios phrases concerning the "purchase" and "transfer" of "bonds" are used. As has been explained in the "key concepts" of Article 8, a person who holds financial assets through an intermediary has a "security entitlement". Security entitlements cannot be "bought" or "sold" but rather are "acquired" or "extinguished". In addition, the rights and interests which comprise a security entitlement are not traceable through to the specific underlying financial asset - a security entitlement holder does not "own the bonds". Such references are therefore colloquial and are used for ease of parlance only.

1) The mischievous intermediary



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with the Central Securities Depository.
3. Customer of the Bank ("A") buys 40 of the 100 bonds from Bank. This is recorded in A's account with Bank.
4. Other customers of the Bank buy the other 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.

5. *Bank, therefore, holds all 100 bonds on behalf of its customers.*
6. *"A" has a customer ("C") who buys 15 of the bonds from it. This is recorded in C's account with A.*
7. *A, therefore, holds 25 of the 40 bonds in its account with Bank for itself and 15 for C.*

Q: If "A" deliberately sells the 40 bonds held in its account with Bank to "B", in contravention of its duties to its customer, "C", who owns what? (such sale would be recorded by a debit to A's account with Bank and a credit B's account with Bank)

Notes:

"B" will have a security entitlement held with an intermediary (here, the Bank). "A" will no longer have a security entitlement with the Bank. This is in contravention of "A's" obligation to its own customer, "C" under Article 8-504 to obtain and maintain sufficient corresponding assets to match the positions of its customers. "A" has to go out and get more bonds to comply with its obligations.

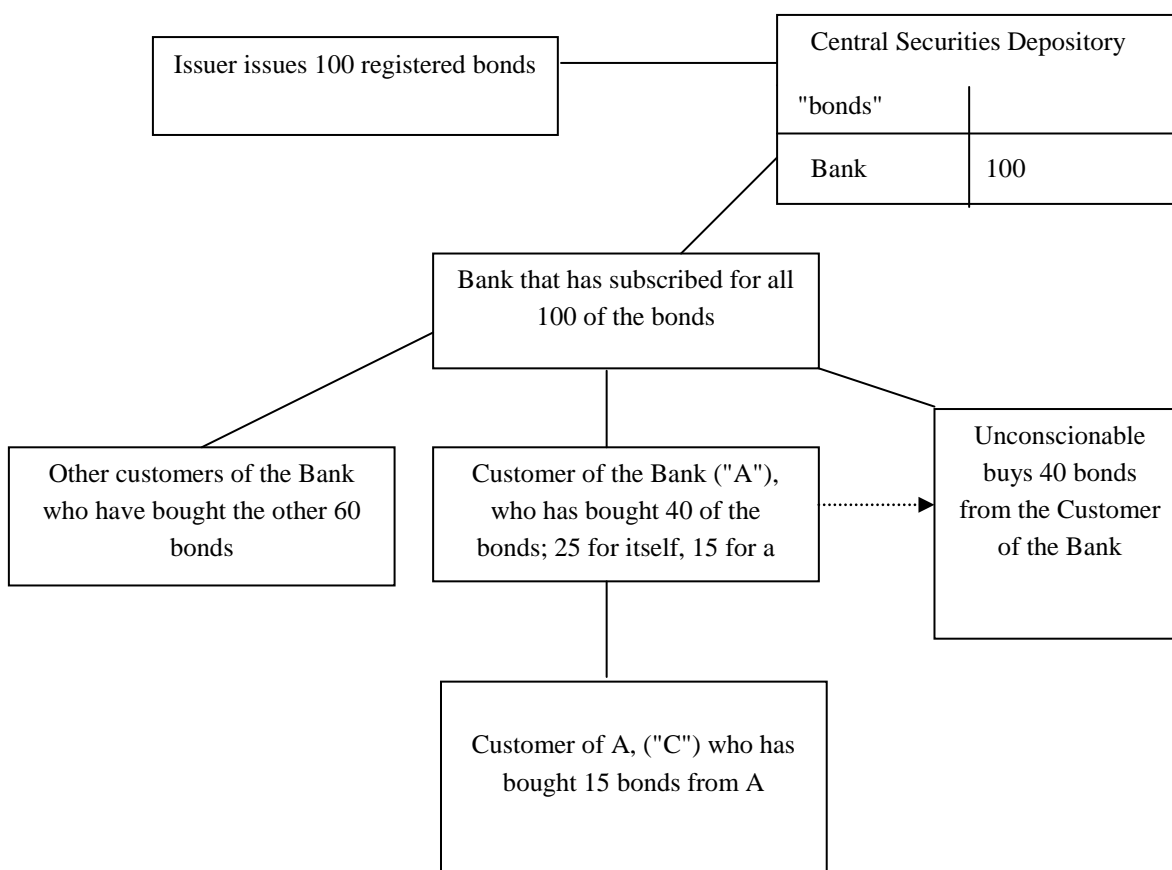
"B" is protected against any claim that "A" transferred the bonds in violation of "C's" property interest in those assets, unless "B" acted in collusion with "A" (Article 8-503(e)).

If "A" is bankrupt, "C's" security entitlement will not be backed by any financial assets held by A in which C could assert its property rights under Article 8-503(b). "C" has a claim in bankruptcy with other creditors. In some cases, the trustee in bankruptcy may bring the Customer of the Bank back to health and may go out and get the 15 bonds to satisfy "A's" obligations under Article 8-504.

If "A" is registered as a broker/dealer, "C" should be protected by regulatory rules and the Securities Investor Protection Corporation Act. The SEC's Rule 15 c 3-3 requires the intermediary to check, on a daily basis, that it is in possession/control of sufficient assets to meet its obligations to its customers. To the extent that the intermediary would be treated as holding a short position for capital purposes (under SEC Rule 15 c 3-1), the entity would have to take a haircut. If, despite these protections, the intermediary cannot meet its obligations, the Securities Investor protection Corporation ("SIPC") would step in. (An array of sales practices potentially giving rise to short positions is also addressed in the National Association of Securities Dealers ("NASD") rules). These comments also apply to scenarios 2- 4 set out in this Annex (to the extent that the relevant intermediary is a broker/dealer).

Bank will only be liable to the adverse claim of "C" if it acted in collusion with "A" in violating "C's" property right.

2) The bad faith purchaser



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer ("A") who buys 40 of the 100 bonds from Bank. This is recorded in A's account with Bank.
4. Other customers of the Bank buy the remaining 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds all 100 bonds on behalf of its customers.
6. "A" has a customer ("C") who buys 15 of the bonds from it. This is recorded in C's account with A.
7. A, therefore, holds 25 of the 40 bonds in its account with Bank for itself and 15 on behalf of C.

Q: If "A" sells 40 bonds to Unconscionable (being someone who knows that 15 of the bonds were bought for "C" and are being sold in contravention of the intermediary's duties to "C"), who owns what? (Such a transfer would be recorded by a debit to A's account with Bank and a credit to Unconscionable's account with Bank).

Notes:

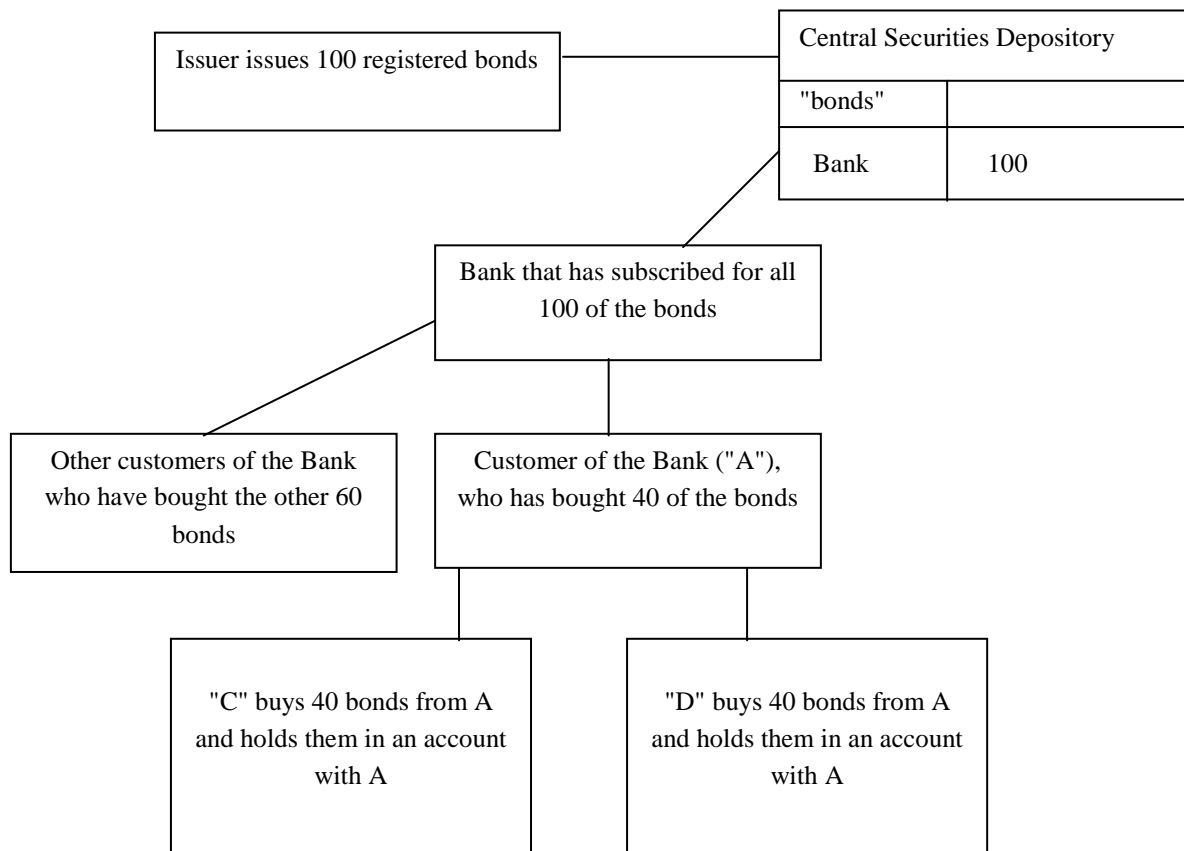
If Unconscionable was aware of a general violation of "C's" property interest (e.g. a theft of the bonds), "C" may bring an adverse claim against Unconscionable (Article 8-502)¹⁴. However, if the claim is specifically that "A" violated "C's" property interest in the bonds by wrongly disposing of its interest in them to Unconscionable, then "C" can only assert an adverse claim if "A" is insolvent and there has been collusion between Unconscionable and "A" (Article 8-503).

Bank will only be liable to the adverse claim of "C" if it acted in collusion with "A" and/or Unconscionable in violating "C's" property right.

¹⁴ Of course it will always be a challenge for any claimant in the fungible net settlement system to operationally trace the bonds to Unconscionable - in most cases there will be no way to find out who got the assets.

3) The double-dealing intermediary

i) Purchasers hold through the same intermediary



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer ("A") who buys 40 of the 100 bonds from Bank. This is recorded in "A's" account with Bank.
4. Other customers of the Bank buy the remaining 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds all 100 bonds on behalf of its customers.

Q: "A" sells 40 bonds to "C" and continues to hold these bonds on behalf of "C" (i.e. "C" is a customer of "A"). "A" and then sells 40 bonds to "D" and continues to hold these bonds on behalf of "D" (a customer of "A"). "A", however, only holds 40 bonds in its account with Bank. Who owns what? (Both sales would be recorded by credits to the accounts of both "C" and "D" held with "A").

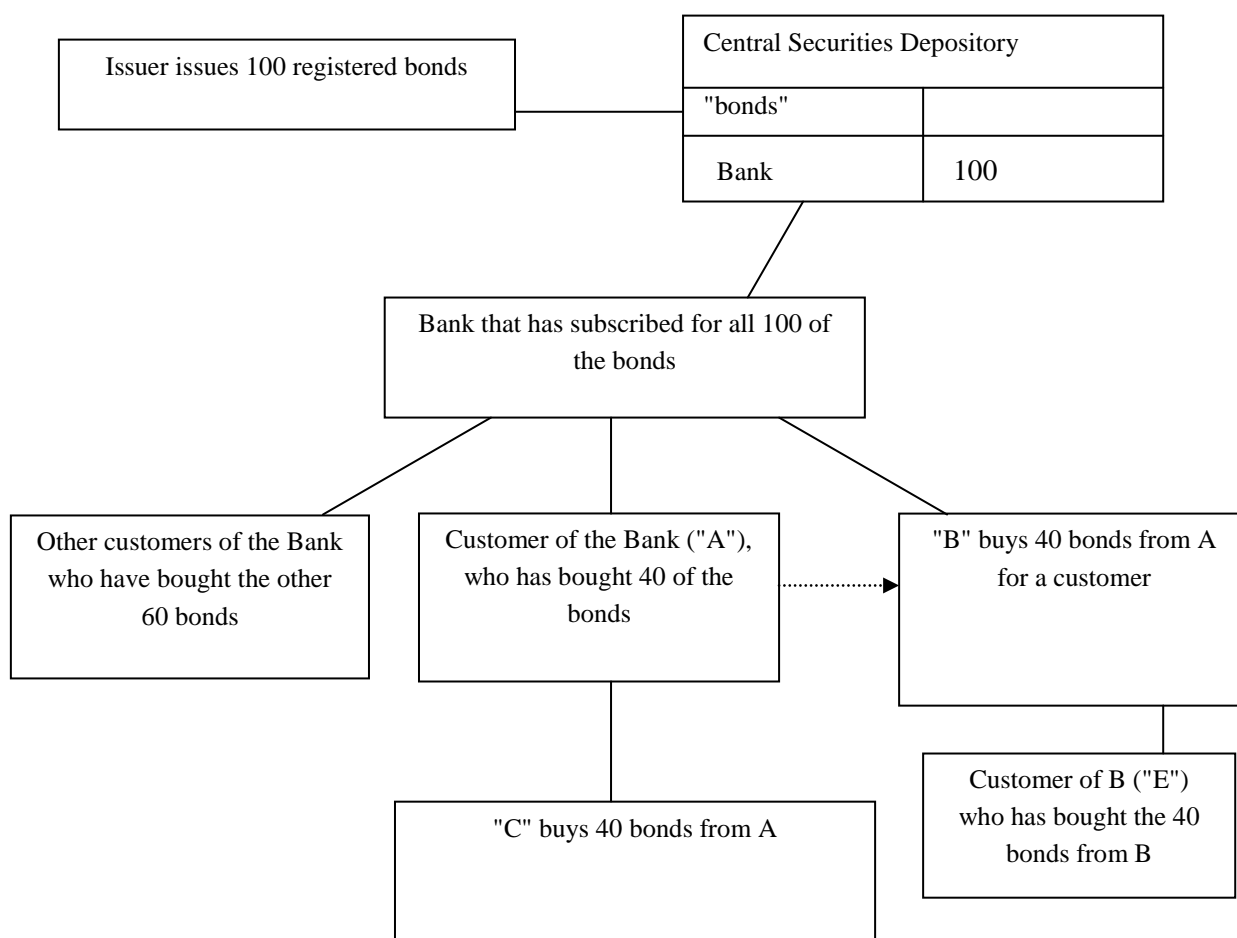
Notes:

If solvent, "A" must go out and get 40 more bonds to comply with Article 8-504. If insolvent, "C" and "D" would share pro rata in the shortfall i.e. 20:20 (Article 8-503(b)).

The security entitlements of the other customers of the Bank who hold the other 60 bonds in accounts with the Bank are unaffected since "C's" and "D's" claims are against "A" only. They have no right to assert their claim against the bonds held by the Bank.

However, as illustrated in scenario (2), the bad faith purchaser, if "A" is insolvent and "D" acted in collusion with the "A" in violating "C's" property interest in the bonds, "C" may have an adverse claim against "D" for the bonds.

ii) Purchasers hold through different intermediaries



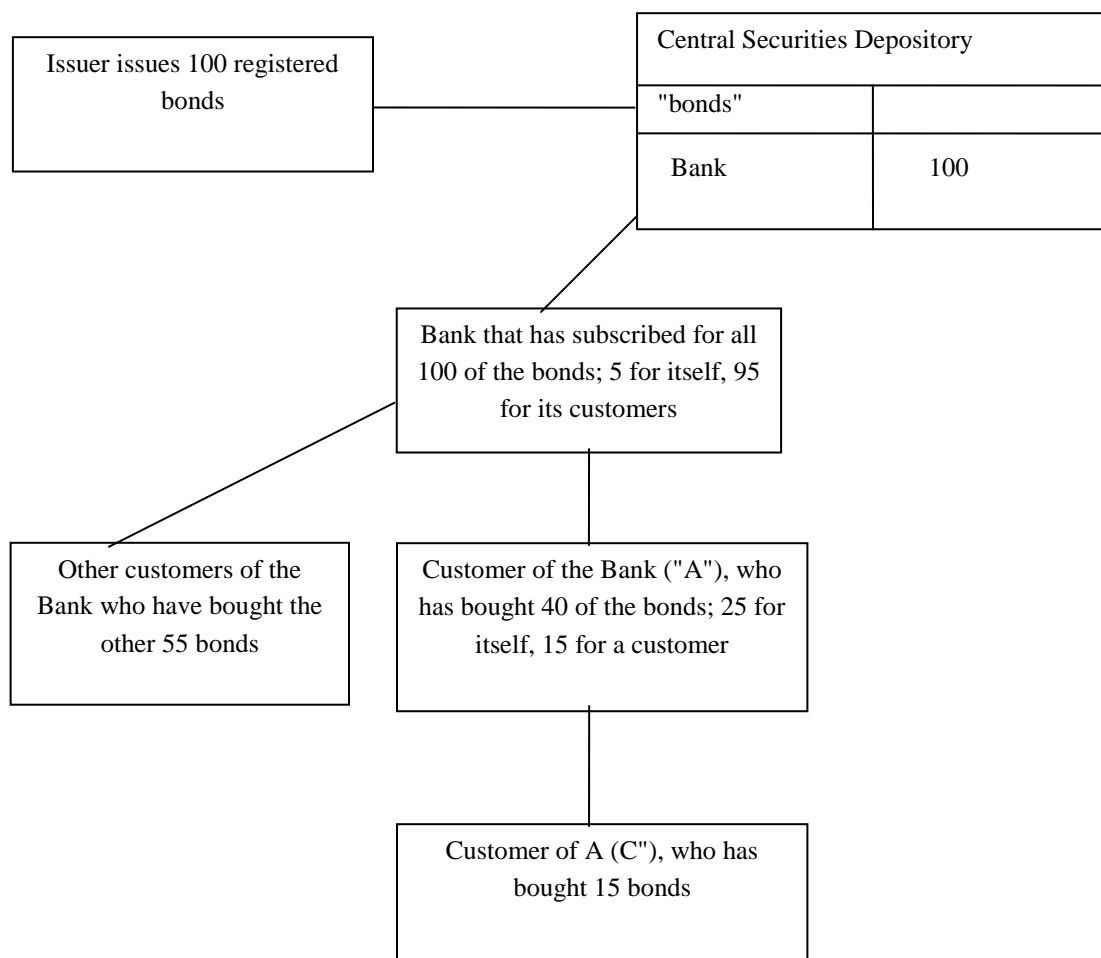
1. Issuer issues 100 bond (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer("A") who buys 40 of the 100 bonds from Bank. This is recorded in "A's" account with Bank.
4. Other customers of the Bank buy the other 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds all 100 bonds on behalf of its customers.
6. "A" Bank sells its 40 bonds to "C" but continues to hold those bonds on behalf of "C". This is recorded in "C's" account with "A".

Q: If "A" sells 40 bonds to "B" who is not its customer but is a customer of Bank, who holds them on behalf of its own customer ("E"), who owns what? (The transfer to "B" would be recorded by a debit to "A's" account with Bank and a corresponding credit to the account of "B" held with Bank. "E's" interest in the bonds would be recorded in "E's" account with "B").

Notes:

"A" will have an obligation to its customer ("C") under Article 8-504 to get 40 more bonds. If "A" is insolvent, "C's" security entitlement will not be backed by any financial assets held by "A" in which "C" could assert its property rights under Article 8-503(b). "B" will have a security entitlement with its intermediary (here, the Bank) and "E" a security entitlement with "B". (Assuming that there was no collusion by either "B" or "E" with "A")

4) A shortfall in the intermediary's securities



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer ("A") who buys 40 of the 100 bonds from Bank. This is recorded in A's account with Bank.
4. Other customers of the Bank buy the remaining 55 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds 95 of the 100 bonds on behalf of its customers and 5 for itself.
6. "A" has a customer ("C") who buys 15 of the bonds from it. This is recorded in C's account with A.

Q: If for any reason the Bank only in fact has 80 bonds in its account with Central Securities Depository, who owns what?

Does the answer differ depending on whether the shortfall arises as a result of the fault of either the Bank or of any identified customer?

Notes:

If the Bank is solvent, it has an obligation to its customers to go out and get more bonds (Article 8-504). In the interim, "A" has a pro rata property interest in the 80 bonds held by the Bank (Article 8-503(b)) (i.e. $\frac{40}{95} \times 80 = 33.68$). Other customers of the Bank have a property right to 46 bonds (i.e. $\frac{55}{95} \times 80 = 46.32$).

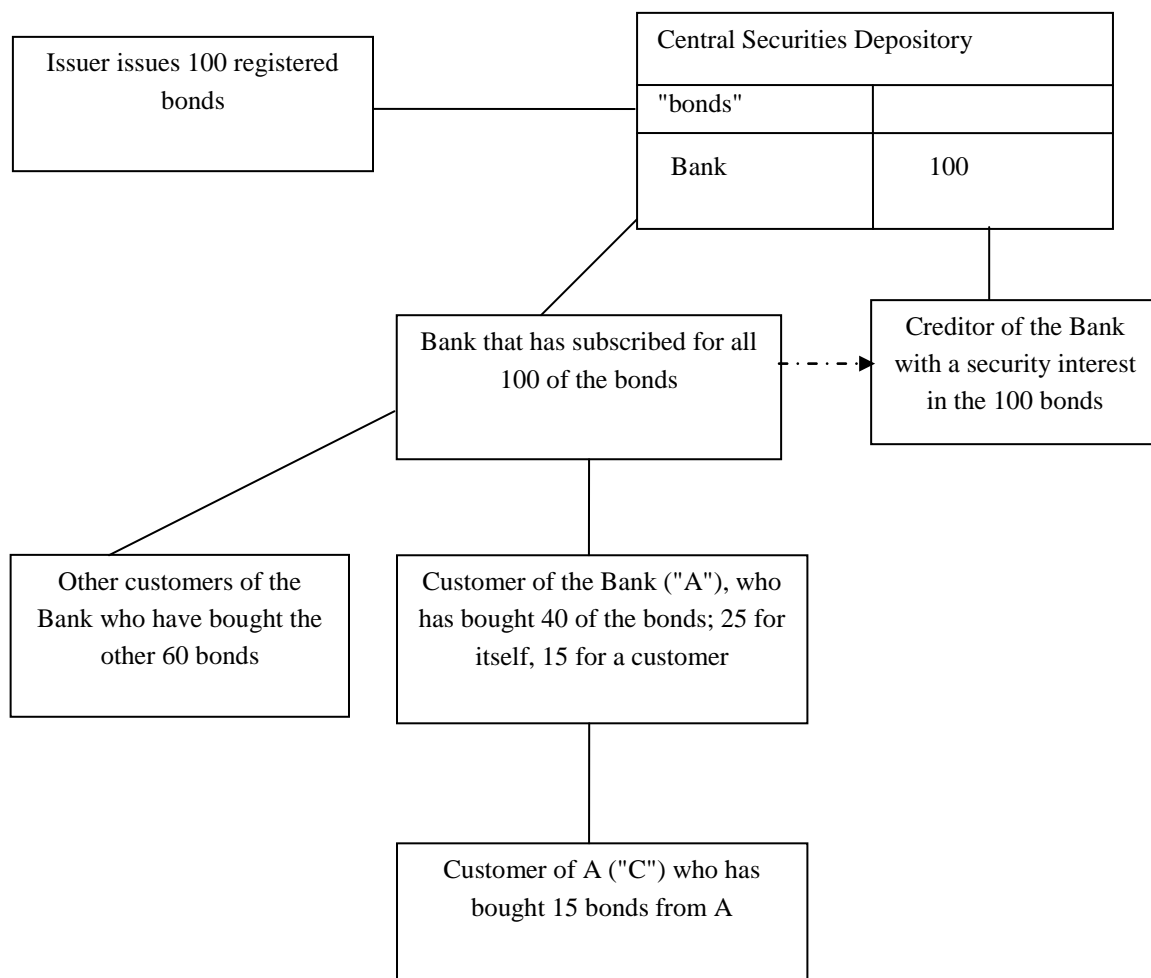
The Bank's own portfolio (the 5 bonds it held on its own behalf) will be included in the distribution in any event and regardless of whether the Bank is at fault (Article 8-503(a)). The Bank will not be entitled to any bonds in the event that there is a shortfall - its obligations to its customers come first.

If the Bank is insolvent, the distribution would be governed by applicable insolvency rules (not SIPC in the case of a Bank).

"C" still has a security entitlement with "A" for 15 bonds. "A" has an obligation (under Article 8-504) to maintain 15 bonds for its customer. "E" would not be affected by the Bank's shortfall and any corresponding shortfall in the bonds held by its own intermediary, "A" (i.e. 15 of the 34 bonds now held in "A's" account(s) are held for "C". "A" bears the loss).¹⁵

¹⁵ The obligation under Article 8-504 is discharged, however, to the extent that the Intermediary acts with respect to the duty as agreed upon by the client and the Intermediary (subject to the overall duty of good faith). For example, the entities may agree that in certain circumstances any loss suffered by the Intermediary as a result of any act of its sub-custodian is to be borne rateably by both the Intermediary and the Client.

5) The Creditor versus Account Holders



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer ("A") who buys 40 of the 100 bonds from Bank. This is recorded in A's account with Bank.
4. Other customers of the Bank buy the remaining 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds all 100 bonds on behalf of its customers.
6. Bank grants a security interest over the 100 bonds in its account with Central Securities Depository to its Creditor.

Q: If the Bank defaults under the terms of the loan granted to it by the Creditor, is the Creditor able to exercise its rights under the security agreement? What about the various customers?

Notes:

If the Creditor has control, the Creditor gets the Bank's bonds on the insolvency of the Bank (to the extent necessary to extinguish the Bank's debt) (Article 8-511(b)). If the

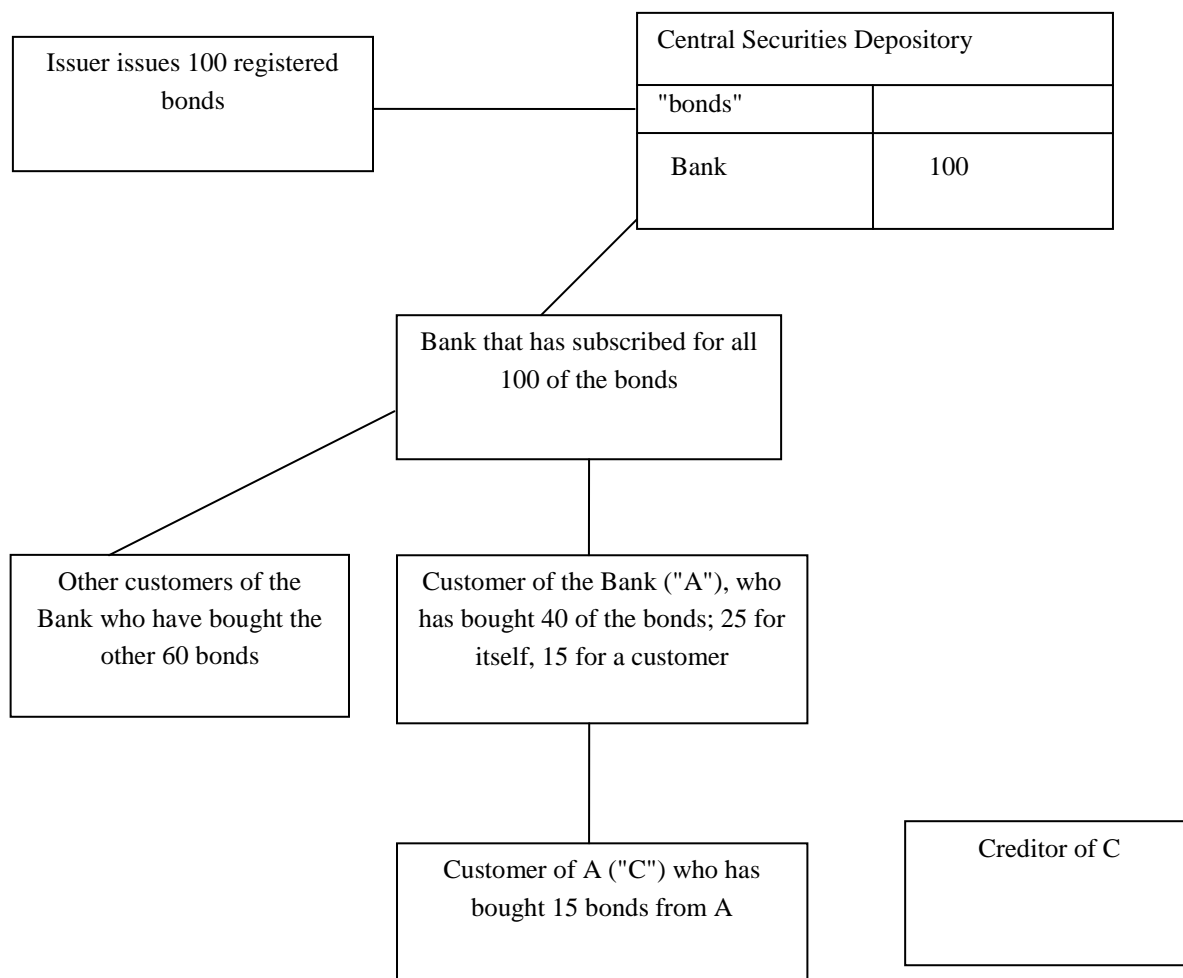
Creditor does not have control, the customers (including "A") of the Bank have priority (Article 8-511(a)).

The security entitlement of the "A" is different property to the property of "C" however, and if "A" is still solvent, it has an obligation (under Article 8-504) to go out and get more bonds to match to its account holder's entitlement. This is so even though "A" will itself only have a claim in bankruptcy against the Bank, if the Bank transferred/sold its bonds to Creditor in breach of Bank's own Article 8-504 obligation to its account holders (provided there was no collusion between the Creditor and the Bank). However, "A" satisfies its duty under Article 8-504 if it acts in a manner agreed upon in its agreement with "C" (Article 8-504(c)(1)).

If "A" consented to the use of the bonds as collateral (for example in a prime brokerage arrangement) and the Bank then defaults on its loan and fails, "A's" claim to the bonds will be subject to any claim Bank may have against it e.g. under a margin loan (Article 8-509(c)(2)) and its entitlement would be adjusted accordingly before distribution.

If the "Bank" is a broker/dealer, the SEC Rules apply. If the securities were fully paid by the investor, the broker/dealer cannot allow a security interest to be created because of its obligation to be in control/possession of the assets under SEC Rule 15c 3-3. This rule, however, allows debits and credits to be off set and as such, if the securities are purchased on margin, there is no possession/control requirement and the broker/dealer can pledge the securities to the Creditor. The broker/dealer will give a representation that the securities are margin securities. If the broker/dealer defaults on its obligations to the Creditor, the broker/dealer still owes its customer the net equity claim of the securities. If the broker/dealer is in SIPC liquidation, SIPC will typically give the customer a choice (to the extent possible) - the customer could pay off the margin and get the securities or SIPC will liquidate the securities and give the customer its net claim.

6) The "Upper Tier Attachment"



1. Issuer issues 100 bonds (which exist in a dedicated named register) and deposits them with a Central Securities Depository.
2. Bank subscribes for all 100 bonds. This is recorded in Bank's account with Central Securities Depository.
3. Bank has a customer ("A") who buys 40 of the 100 bonds from Bank. This is recorded in A's account with Bank.
4. Other customers of the Bank buy the remaining 60 bonds from Bank. This is recorded in the other customers' accounts with Bank.
5. Bank, therefore, holds all 100 bonds on behalf of its customers.
6. "C", a customer of A buys 15 of the bonds from A. This is recorded in C's account with A.
7. C grants a security interest over the 15 bonds in its account with A to its Creditor.

Q: If "C" defaults under the terms of the loan granted to it by the Creditor, can the Creditor go to "A", Bank or to Central Securities Depository directly and claim the 15 bonds?

Notes:

Creditor may go to "A" and claim a right to "C's" bonds if it does so by legal process (Article 8-112). Creditor cannot assert its interest in the bonds any higher up the chain of intermediaries (i.e. against Bank or Central Securities Depository).

"A" may not be liable to Creditor unless it disposes of the bonds without an effective entitlement order (from "C" or "C's" agent) or, unless it disposes of the bonds pursuant to an effective entitlement order but does so after it has been served by any legal process prohibiting it from doing so or is in collusion with "C" or any transferee of the bonds in violating Creditor's rights to the bonds (Article 8-115).

Schedule 2

Key Principles of Article 8 and relevant parts of Article 9

This table sets out the principles that have been developed by the Working Group as a potential framework for a proposed statute to govern the indirect holding of securities in the United Kingdom. For each of these principles, the table identifies the relevant provisions of Article 8 so that a broad comparison may be made.

| <p align="center">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p align="center">UCC ARTICLE 8 (1994 REVISION)</p> |
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| <p>1. Application</p> <p><i>Indirectly held securities:</i> The principles apply where securities are held by a client through an intermediary. The principles do not apply where investment securities are held directly (for example where the name of an investor in shares is entered on the share register).</p> | <p>Article 8-102(a)(9) "Financial asset," except as otherwise provided in Section 8-103, means:</p> <ul style="list-style-type: none"> (i) a security; (ii) an obligation of a person or a share, participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on financial markets, or which is recognized in any area in which it is issued or dealt in as a medium for investment; or (iii) any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a <u>financial asset</u> under this Article. <p>As context requires, the term means either the interest itself or the means by which a person's claim to it is evidenced.</p> <p>Article 8-102(a)(15) "Security," except as otherwise provided in Section 8-103, means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:</p> <ul style="list-style-type: none"> (i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books |

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| | <p>maintained for that purpose by or on behalf of the issuer;</p> <p>(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and</p> <p>(iii) which:</p> <p>(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or</p> <p>(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.</p> |
| | <p>Article 8-102(a)(13) "Registered form," as applied to a certificated security, means a form in which:</p> <p>(i) the security certificate specifies a person entitled to the security; and</p> <p>(ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states.</p> <p>Article 8-102(a)(2) "Bearer form," as applied to a certificated security, means a form in which the security is payable to the bearer of the security certificate according to its terms but not by reason of an endorsement</p> <p>Article 8-102(a)(4) "Certificated Security" means a security that is represented by a certificate.</p> <p>Article 8-501(a) "Securities account" means an account to which a financial asset is or may be credited in accordance with an agreement under which the party maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that</p> |

| <p align="center">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p align="center">UCC ARTICLE 8 (1994 REVISION)</p> |
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| | <p>comprise the financial asset.</p> |
| <p><i>Business only:</i> The principles do not apply to non-business arrangements.</p> | <p>Article 8-102(14) "Securities intermediary" means:</p> <ul style="list-style-type: none"> (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity. <p>Article 8-501(b) ... a person acquires a security entitlement if a securities intermediary ...</p> |
| <p><i>Contracting out:</i> The intermediary and client may contractually modify or disapply the principles, so far as they relate to their mutual rights and duties.</p> <p><i>Consistent with collateral legislation:</i> The Statute should be consistent with the Financial Collateral Directive and the Law Commission proposals set out in CP 164.</p> <p><i>Not affect terms of issue:</i> The principles do not affect the terms of issue of securities.</p> | <p>Article 1-102(3) the provisions may be varied by agreement (except where otherwise provided in the provisions and except that the obligations of good faith, diligence, reasonableness and care prescribed by the provisions may not be disclaimed by agreement but the parties may by agreement determine the standards by which performance of such obligations be measured insofar as such standards are not manifestly unreasonable).</p> |
| <p>2. Interests in Securities</p> <p>(a) <i>Client's rights</i> The rights of each client in relation to securities held by it through an intermediary are together called "interests in</p> | <p>Article 8-102(17) "Security entitlement" means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.</p> <p>Article 8-503(b) An entitlement holder's property</p> |

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| <p>securities". Interests in securities include both personal rights against the intermediary and property rights in relation to the securities, as follows.</p> <p>(b) <i>Property rights in pool</i> Each client which holds securities of a particular type through an intermediary has proportionate property rights in the pool to the extent of its entitlement.</p> <p>(c) <i>Meaning of pool</i> For this purpose "pool" means the sum of all securities of a particular type in the possession of the intermediary or credited to any account maintained by the issuer, or another intermediary, in the name of the intermediary or its nominee(s).</p> | <p>interest with respect to a particular financial asset ... is a pro rata property interest in all interests in that financial asset held by the securities intermediary ...</p> |
| <p>3. Intermediary's duties:</p> <p>Subject to contrary agreement by the intermediary and the client.</p> <p>(i) The intermediary must pass on to clients all income and other benefits associated with the securities held by clients through it. It must implement any voting instructions received from the client.</p> <p>(ii) The intermediary must record the client's interests in securities in the account(s) it maintains in its books in favour of each client ("client account").</p> | <p>Article 8-506 A securities intermediary shall exercise rights with respect to a financial asset if directed to do so by an entitlement holder (subject to agreement between the securities intermediary and the entitlement holder as to how the duty is discharged/due care in accordance with reasonable commercial standards or placing the entitlement holder in a position to exercise the rights directly).</p> <p>Article 8-505(a) A securities intermediary shall take action to obtain a payment or distribution made by the issuer of a financial asset (subject to agreement between the securities intermediary and the entitlement holder as to how the duty is discharged/due care in accordance with reasonable commercial standards).</p> <p>Article 8-505(b) A securities intermediary is</p> |

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| <p>(iii) The intermediary must ensure that securities held in the pool are sufficient securities to satisfy all clients' interests in securities.</p> | <p>obligated to its entitlement holder for a payment or distribution made by the issuer of a financial asset if the payment or distribution is received by the securities intermediary.</p> |
| | <p>Article 8-504 A securities intermediary shall promptly obtain and maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favour of its entitlement holders with respect to that financial asset (subject to agreement between the securities intermediary and the entitlement holder as to how the duty is discharged/due care in accordance with reasonable commercial standards).</p> <p>Article 8-507 A securities intermediary shall comply with a notification directing transfer or redemption of a financial asset to which an entitlement holder has a security entitlement if the notification is given by the entitlement holder [or if deceased, its successor/personal representative or if it lacks capacity, its guardian/conservator or other similar representative], the securities intermediary has had reasonable opportunity to assure itself that the entitlement order is genuine and authorised, and the securities intermediary has had reasonable opportunity to comply with the notification (subject to agreement between the securities intermediary and the entitlement holder as to how the duty is discharged/due care in accordance with reasonable commercial standards).</p> <p>Article 8-508 A securities intermediary shall comply with a direction of an entitlement holder to change a security entitlement into another available form of holding, or cause the financial asset to be transferred to a securities account the entitlement holder has with another securities intermediary (subject to agreement between the securities intermediary and the entitlement holder as to how</p> |

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| | <p>the duty is discharged/due care in accordance with reasonable commercial standards).</p> <p>Article 8-509 If the substance of a duty imposed upon a securities intermediary by Articles 8-504 to 8-508 is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty.</p> |
| <p><i>Enforcement of client's rights:</i> Clients (and persons claiming through them including attachment creditors) can enforce their interests in securities only against the intermediary, and not against the issuer or any other intermediary. However, this is subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities, or of a deed poll or contract or arising under general law against persons not acting in good faith.</p> | <p>Article 8-503(c) An entitlement holder's property interest with respect to a particular financial asset may be enforced against the securities intermediary only by exercise of the entitlement holder's right under Articles 8-505 to 8-508.</p> <p>Article 8-506 - see intermediary's duties above.</p> <p>Article 8-503(d) An entitlement holder's property interest with respect to a particular financial asset may be enforced against a purchaser of the financial asset or interest therein only if:</p> <ol style="list-style-type: none"> (1) insolvency proceedings have been initiated against the securities intermediary; (2) the securities intermediary does not have sufficient interests in the financial asset to satisfy the security entitlements of all its entitlement holders to that financial asset; (3) the securities intermediary violated its obligations under Article 8-504 by transferring the financial asset or interest therein to the purchaser; and (4) the purchaser is not [a] protected [purchaser]... If the trustee or other liquidator elects not to [recover the financial asset or interests therein from the purchaser] ... <p>Article 8-112(c) The interest of a debtor in a</p> |

| <p align="center">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p align="center">UCC ARTICLE 8 (1994 REVISION)</p> |
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| | <p>security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained except... (d) The interest of a debtor in a ... security entitlement maintained in the name of a secured party, may be reached by a creditor by legal process upon the secured party.</p> |
| <p><i>Client instructions</i> The intermediary must act, and act only, on the instructions of the client and/or the client's duly authorised agent in relation to interests in securities and/or securities held by clients through it. The intermediary acting honestly may rely on such instructions, notwithstanding any notice it may have of third party claims.</p> | |
| <p>4. Shortfalls</p> <p>(a) <i>Shortfalls:</i> Any shortfalls in the pool will be borne, firstly, by the intermediary and secondly by all clients participating in the pool, in proportion to their entitlements.</p> | <p>Article 8-503(b) An entitlement holder's property interest with respect to a particular financial asset ... is 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 ...</p> <p>[Subject to Insolvency law]</p> |
| <p>5. Insolvency Immunity</p> <p>Securities held by the client through an intermediary that are not available to the creditors of the intermediary.</p> | <p>Article 8-503(a) To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities</p> |

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| | <p>intermediary [except where the creditor has a security interest in that financial asset in which case, the claims of the entitlement holders have priority over the claim of the creditor unless either (i) such creditor has control or (ii) the intermediary is a clearing corporation where in both such cases, the creditor has priority: Article 8-511]</p> |
| <p>6. The Attachment of Third Party Interests</p> <p><i>No formalities:</i> An interest in favour of a person (X) other than the client in interests in securities may be created without any entries on the client account, public filings or other formalities or the transfer of control, for example by the agreement of X and the client, or by trust ("informal dealings").</p> <p><i>Unperfected and weak priority:</i> However, informal dealings may not be enforceable against third parties, and may be overridden by subsequent dealings where control is transferred and/or which are indicated on the client account.</p> | |
| <p>7. The Perfection of Third Parties</p> <p><i>Transfer of Control:</i> Dealings in interests in securities (including outright transfers and security interests) are made enforceable against third parties by the transfer of control. No further formalities are required.</p> | <p>[Article 9-115(4) A security interest in investment property may be perfected</p> <p>(a) By control</p> <p>(b) By filing</p> <p>(c) If the debtor is a broker or securities intermediary,.....when it attaches</p> <p>(d) If a debtor is a commodity intermediary.....when it attaches - 1994 Article 8 revision. Disappeared in 2001 revision New Article 9-309(9), (10), (11)]</p> |

| <p style="text-align: center;">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p style="text-align: center;">UCC ARTICLE 8 (1994 REVISION)</p> |
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| | <p>[Article 9.203] a security interest is enforceable against the debtor and third parties with respect to the collateral only if:</p> <ol style="list-style-type: none"> (1) Value has been given; (2) The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and (3) One of the following conditions is met: <ol style="list-style-type: none"> (A) The debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned; (B) The collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement; (C) The collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; or (D) The collateral is deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights, and the secured party has control under Section 9-104, 9-105, 9-106, or |

| PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE | UCC ARTICLE 8 (1994 REVISION) |
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| | 9-107 pursuant to the debtor's security agreement. |
| <p><i>Meaning of Control:</i> "Control" means legal, or legal and operational, control. A person has control of interests in securities if it is entitled, or entitled and able, to direct how they shall be dealt with. For example, X may take control by having the interests in securities credited to its own account. Alternatively, it may leave them in the client's account, but obtain the agreement of the intermediary that it will deliver the interests in securities in accordance with X's instructions without further consent of the client. Whether the client could itself continue to operate the client account would depend on its agreement with X. Where interests in securities are agreed to be given as security to the intermediary itself, no further step is required to perfect such security.</p> | <p>Article 8-106(d) A purchaser has "Control" of a security entitlement if (1) the purchaser becomes the entitlement holder; or (2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder; [or (3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.]¹⁶</p> <p>Article 8-106(e) If an interest in a security entitlement is granted by the entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control.</p> <p>Article 8-106(f) A purchaser who has satisfied these requirements has control even if the entitlement holder retains the right to make substitutions for the security entitlement, to originate entitlement orders to the securities intermediary, or otherwise to deal with the security entitlement.</p> |
| <p>8. Priorities</p> <p>The following rules apply where there are competing claims to interests in securities.</p> | |

¹⁶ This sub-paragraph was inserted by the 1998 revision of Article 9 with 2001 amendments.

| <p style="text-align: center;">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p style="text-align: center;">UCC ARTICLE 8 (1994 REVISION)</p> |
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| <p><i>Account finality:</i> The intermediary shall not take notice of third party claims which are not indicated on the client's account, unless it is ordered by the court to do so.</p> | <p>Article 8-115 A securities intermediary ... is not liable to a person having an adverse claim to the financial asset, unless the securities intermediary ...</p> <ol style="list-style-type: none"> (1) took ... action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so...; or (2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or (3) in the case of a securities certificate that has been stolen, acted with notice of the adverse claim. |
| <p><i>Purchase money priority:</i> Where the intermediary lends to the client the purchase price of interests in securities, its security interest over those interests in securities for the repayment of the purchase price takes priority over any competing security interests.</p> | <p>Article 9-206 If a person buys a financial asset through a securities intermediary in a transaction in which the buyer is obligated to pay the purchase price to the securities intermediary at the time of the purchase, and the securities intermediary credits the financial asset to the buyer's security account before the buyer pays the securities intermediary, the securities intermediary has a security interest in the buyer's security entitlement securing the buyer's obligation to pay.</p> <p>Article 9-328(c) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.</p> <p>Article 8-106(e) (see definition of "Control" above).</p> <p>[Article 8-510(d) A securities intermediary as purchaser has priority over a conflicting purchaser who has control unless otherwise agreed by the securities intermediaries.]¹⁷</p> |

¹⁷ This provision was inserted by the 1998 revision of Article 9 with 2001 amendments.

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| <p><i>Control priority; account priority:</i> In the case of successive dealings, a person acquiring control has priority over a person not acquiring control. As between two persons acquiring control, the person whose interest is first reflected in the account has priority. As between two persons acquiring control which is not reflected in the account, priority is determined by the order in which control is acquired.</p> | <p>Article 9-328 The following rules govern priority among conflicting security interests in the same investment property:</p> <ul style="list-style-type: none"> (a) a security interest held by a secured party having control ... has priority over a security interest held by a secured party that does not have control ... (b) conflicting security interests held by secured parties each of which has control ... rank according to priority in time of: <ul style="list-style-type: none"> 1) becoming the person for which the securities account is maintained; 2) the securities intermediary's agreement to comply with the secured party's entitlement orders; or 3) if control is through another person, the time on which priority would be based if the other person were the secured party ... (c) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party. (d) conflicting security interests created by a broker, securities intermediary ... which are perfected without control ... rank equally. (e) In all other cases, priority ... is governed [according to rules in Article 9-322]. <p>Article 9-322</p> <ul style="list-style-type: none"> (1) Conflicting perfected security interests ... rank according to priority in time of filing or |

| <p align="center">PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE</p> | <p align="center">UCC ARTICLE 8 (1994 REVISION)</p> |
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| | <p>perfection ...</p> <p>(2) A perfected security interest ... has priority over a conflicting unperfected security interest ...</p> <p>(3) the first security interest ... to attach or become effective has priority if conflicting security interests .. are unperfected.</p> <p>Article 8-510(c) A purchaser for value of a security entitlement, or an interest therein who obtains control has priority over a purchaser of a security entitlement, or an interest therein, who does not obtain control. Purchasers who have control rank¹⁸ according to priority in time of (1) becoming the person for whom the securities account in which the security entitlement is maintained; (2) agreement with the securities intermediary to comply with the purchaser's entitlement orders; or (3) if another person has control of the asset on behalf of the purchaser, the time on which priority would be based if that other person were the secured party.</p> |
| <p><i>Good Faith Purchaser:</i> In the case of fraudulent or other wrongful disposition by the intermediary, a good faith purchaser without notice of the fraud or other wrong takes free of client claims. (Where the purchase is settled by debits and credits to an account maintained by the same intermediary, the shortfall provisions in [these principles] will apply.</p> | <p>Article 8-116 A securities intermediary that receives a financial asset and establishes a security entitlement to the financial asset in favour of an entitlement holder is a purchaser for value of the financial asset. A securities intermediary that acquires a security entitlement to a financial asset from another securities intermediary acquires the security entitlement for value if the securities intermediary acquiring the security entitlement establishes a security entitlement to the financial asset in favour of an entitlement holder.</p> <p>Article 8-502 An action based on an adverse claim</p> |

¹⁸ The ALI-NCCUSL 1994 revision of Article 8 provided that purchasers who have control rank equally, except that a securities intermediary as purchaser has priority over a conflicting purchaser who has control unless otherwise agreed by the securities intermediary. This was amended by the 1998 revision of Article 9 with 2001 amendments.

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| | <p>to a financial asset ... may not be asserted against a person who acquires a security entitlement ... for value and without notice of the adverse claim.</p> <p>Article 8-503(e) An action based on the entitlement holder's property interest with respect to a particular financial asset.... may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary....</p> <p>Article 8-510(a) An action based on an adverse claim to a financial asset or security entitlement ... may not be asserted against a person who purchases a security entitlement, or an interest therein, from an entitlement holder if the purchaser gives value, does not have notice of the adverse claim, and obtains control.</p> <p>Article 9-331(c) Filing under Article 9 does not constitute notice of a claim or defence to the holders, or purchasers, or [persons protected against the assertion of a claim under Article 8].</p> |
| <p>9. Set-Off</p> <p>Where the client holds interests in securities for its own account, and has good title to such interests in securities free from any defences or rights of set-off of its intermediary, and where the client owes a debt to the issuer of the securities, the pooling of the securities in the hands of the intermediary should not prevent the exercise of any rights of set-off which would otherwise be exercisable as between the issuer and the client.</p> | |

Schedule 3

Resources and materials

The Uniform Commercial Code (the "UCC") is a model law and the joint product of two non-governmental bodies, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI).

The "Official Text" of the UCC has been approved by both bodies which means that they recommend that the individual states adopt the text as part of their own statutory law. It does not, of itself, have the force of law.

The revision of Article 8 was approved by NCCUSL and ALI at their annual meetings in the summer of 1994. It has, to date, been adopted by law in [31] states.

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The text of the New York state adopted version of Article 8 is available on the New York State Assembly's website at www.assembly.state.ny.us/leg/?cl=122