

**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

Financial Markets Law Committee  
c/o Bank of England  
Threadneedle Street  
London EC2R 8AH  
[www.fmlc.org](http://www.fmlc.org)

## **FINANCIAL MARKETS LAW COMMITTEE**

### **ISSUE 3 - PROPERTY INTERESTS IN INVESTMENT SECURITIES WORKING GROUP**

Chair: Professor Sir Roy Goode QC, St Johns College, Oxford University.

Secretary: Kirsty Devonport, Clifford Chance.

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Habib Motani, Clifford Chance.

Gabriel Moss QC, 3/4 South Square.

Edward Murray, Allen & Overy.

Martin Thomas, Financial Markets Law Committee.

Philip Wood, Allen & Overy.

Madelene Yates, Clifford Chance.

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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;

Richard Potok, Potok & Co.;

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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. In relation to the grant of security interests in investment securities and other financial assets Article 8 must be read in conjunction with Article 9.

## 2. THE EVOLUTION OF ARTICLE 8

When Article 8 was first promulgated over 50 years ago the system for the holding of securities possessed two principal characteristics: the investor held its securities directly from the issuer and its entitlement to the securities, whether issued in registered or in unregistered form, was

embodied in certificates which were transferable by delivery. The huge growth in the securities market produced a volume of paper that threatened to overwhelm the clearance and settlement system. The response of the market was to circumvent the need for the cumbersome delivery of physical certificates back and forth amongst market participants by depositing securities with a common depository. Thus, the depository's records identify its participants' interests in those securities and the books of those participants reveal the interests of their customers. Such immobilisation of securities led to the increased reliance on an "indirect" or "intermediated" holding system in which transfers are settled by adjustments to the accounts of the depository or another intermediary in the chain of the holding system. The legislative response which led to the 1978 amendments to Article 8, however, did not go quite this far but rather envisaged a move to the dematerialisation of securities. 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 in a register rather than proprietary rights in any physical instrument. But Article 8 continued to posit a direct holding system even after the market had evolved to rely increasingly on the intermediated system by which investors held and transferred their securities through a securities account with a custodian or other securities intermediary (whether those securities were immobilised or dematerialised). Accordingly Article 8 was extensively revised in 1994 so as to accommodate both the traditional direct holding system and the system of indirect holdings, while maintaining strict neutrality as between them. The revised Article 8 applies not only to interests in securities but also to tradable obligations, participations and the like, all of these being subsumed by § 8-102(a)(9) under the label "financial assets".

A central concern of markets and regulators is systemic risk. This is particularly true of the securities markets, where the daily turnover of securities is huge. This makes it essential to have an efficient clearing and settlement system underpinned by legal rules which promote certainty, settlement finality and the expeditious conduct of business and which are responsive to the legitimate needs and practices of the market. That is the primary objective of Article 8 and, in relation to security in financial assets, Article 9.

### 3. 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".<sup>1</sup>

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 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.

#### 4. SCOPE AND DEFINITIONS

Article 8 is confined to the settlement phase of securities transactions, dealing with the manner in which rights and interests in financial assets are acquired and transferred and the consequential rights and duties of the parties involved. In other words, it deals with the settlement of a trade, not with the trade itself. It is confined to financial assets, and in relation to the indirect holding system, which is governed by Part 5 of Article 8, it is concerned with an

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<sup>1</sup> "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

entitlement holder's rights ("security entitlements") held in a securities account with a securities intermediary. Under Article 8 special protections are given to those who obtain control of a financial asset, while under Article 9 a secured party who perfects by control has priority over those perfecting by other means. All these terms are defined.

*Control.* A purchaser has control of a security entitlement if (1) it becomes the entitlement holder, (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, acknowledges that it has control on behalf of the purchaser: § 8-106(d).

*Entitlement holder* is a person identified in the records of a securities intermediary as a person having a securities entitlement against the intermediary: § 8-102(a)(7)

*Financial asset* is defined by § 8-102(a)(9) in terms covering a security, obligations tradable on financial markets or recognised as a medium for investment and any property held by a securities intermediary for another person in a securities account if the intermediary has expressly agreed with the other person to treat it as a financial asset under Article 8. The term does not include commodities contracts.

*Perfection* denotes the act - filing, possession, control or otherwise - necessary to render a security interest effective against the debtor's trustee in bankruptcy. It may or may not confer priority over other interests, this being determined by separate priority rules.

*Securities account* is an account with a securities intermediary to which a financial asset is or may be credited in accordance with an agreement under which the securities intermediary agrees to treat the account holder as entitled to exercise the rights comprising the financial asset: § 8-501(a)

*Securities intermediary* is 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: § 8-102(a)(14)

*Security* is defined by § 8-102(a)(15) and in broad terms covers obligations of an issuer, or a share, participation or other interest in an issuer or in property or an enterprise of an issuer which (i) is represented by a security certificate in bearer or registered form or is transferable across the issuer's books, (ii) is divisible and (iii) is tradable on a market or is a medium for investment and by its terms expressly provides that it is a security governed by Article 8.

*Security entitlement* means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5: § 8-102(a)(17)

## 5. KEY FEATURES OF ARTICLE 8<sup>2</sup>

In relation to indirect holdings of securities interviewees identified the following key features of Article 8 as revised in 1994:

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<sup>2</sup> For a detailed account of the history, policies and principles of Article 8 see James Steven Roger, 'Policy Perspectives on Revised U.C.C. Article 8' 43 UCLA L Rev 1431.

- Article 8 recognises that the source of the investor's entitlement with respect to a financial asset is no longer the issuer's register or physical certificates but its securities account with its own intermediary, the only party with whom the investor typically has a relationship.
- In relation to its intermediary the investor holds a package of rights, labelled a "security entitlement" and consisting of a mixture of personal rights - for example, the right to require the intermediary to deliver or transfer the asset in accordance with the investor's instructions and to obtain receipt of dividends and distributions on the investor's behalf - and a pro rata property interest in the totality of the interests in a financial asset held by the intermediary, whether on its own account or for its account holders, to the extent necessary to satisfy all the security entitlements of the account holders: § 8-503.
- To the extent necessary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset, whether held by the intermediary in its client account or its house account are held for the entitlement holders, are not property of the intermediary and are not subject to claims of general creditors of the intermediary: § 8-503(a). Article 8 does not require the segregation of client assets and does not distinguish between financial assets held in an intermediary's client account(s) and those held in its house account. As such, a client will only be prejudiced by a shortfall in financial assets held by the intermediary to the extent that the intermediary does not hold sufficient corresponding financial assets to match the client(s)' security entitlements in both the client account(s) and its house account: § 8-503(a).
- Under § 8-503(b) the pro rata interest is determined without regard to the time the entitlement holder acquired the security entitlement or the time the intermediary acquired the interest in the financial asset - in other words, all account holders have a pro rata interest regardless of the order in which their respective interests were acquired or the fact that at the time a particular account holder's entitlement arises the intermediary does not have a sufficient quantity of the asset to meet all claims. This reflects the reality that, given the chains of intermediaries and the use of multilateral clearing systems, it is often impossible to match a particular entitlement or holding to a particular acquisition or disposal by the intermediary. The effect is to enhance the finality of dispositions, whether absolute or by way of security, effected by book entry and to ensure that any shortfall in the intermediary's holdings is borne by the investors pro rata and not by any particular investor. Account finality is a central concept of Article 8.
- An investor's relationship is solely with its own intermediary, and there is no right to 'look through' the intermediary in order to assert a claim against an upper-tier intermediary or the issuer; indeed, in most cases such a tracing exercise would be impossible and, even if possible, would involve delay and expense wholly incompatible with the needs of a fast-moving market. For the same reason a creditor of an investor can in most cases only attach the investor's account with the investor's intermediary and not an account of the latter with an upper-tier intermediary: § 8-112(c). It follows that each entitlement is a distinct property right, so that when a financial asset credited to A's account with Intermediary 1 is then sold to B and transferred to the credit of B's account with Intermediary 2, B's rights stem from and are exercisable solely against

Intermediary 2, and are not derived from Intermediary 1. The position would be otherwise if and so long as B's purchase was not reflected in an account with its own intermediary, e.g. if A created an interest in favour of B but there was no credit or debit of accounts, in which case B's rights would derive from A's accounts. However, the every day account holder wishing to dispose of securities will not be concerned with the identity of the transferee but will simply give instructions to his intermediary to sell the securities in question. As there will usually be a chain of intermediaries and the transfer will be one item in a large number of items netted out in the clearing there will generally be no way of determining into whose hands the securities have come. Accordingly in contrast to the position as regards physical assets it will rarely be the case that a party asserting that his intermediary has made a wrongful disposition of securities will be able to identify the person into whose hands they have come except where both parties hold their accounts with the same intermediary so that there is an in-house transfer. Hence the rule that each securities account must be treated in isolation from other accounts and, as a corollary, that a party's claim lies solely against its own intermediary.

- The intermediary is entitled to act on its account holder's instructions without regard to adverse claims, even where it has notice of them, except in a few cases, e.g. where acting in collusion with the wrongdoer: § 8-115. The purpose of this is to enable intermediaries to act promptly on their account holders' instructions without having to make judgments about the validity of an adverse claim.
- An adverse claim cannot be asserted against a purchaser for value of an interest in a security entitlement who obtains control and does not have notice of the adverse claim: § 8-510. Moreover, where a securities intermediary disposes of an entitlement holder's interest in violation of the latter's rights, a purchaser for value who obtains control and does not act in collusion with the intermediary is protected: § 8-503(e).
- Article 8 continues to recognise the efficacy of the right of re-use (including sale), where agreed upon by the parties and to permit self-help access to collateral without judicial intervention.

## 6. SECURITY INTERESTS IN INVESTMENT PROPERTY

Security interests in investment property are governed by Article 9 of the Uniform Commercial Code. ("Investment property" covers not only financial assets but also commodity contracts and commodity accounts: § 9-102(a)(49)). Such interests may be perfected by filing or by control as provided by § 8-106: § 9-314(a). In a priority contest perfection by control trumps other methods of perfection: § 9-328(a). A security interest in favour of the investor's securities intermediary has priority over a security interest in favour of any other secured creditor: § 9-328(c).

## 7. LESSONS FROM AMERICA

Article 8 is essentially practical in character. Where necessary it departs from traditional legal concepts in order to produce sensible outcomes in typical situations. It is not, however, conceived as revolutionary. Rather it reflects a desire to adapt existing concepts and rules so as to make them suitable for indirect holdings of securities through accounts with intermediaries.

To that end it modifies traditional concepts of property based on rules of tracing in traditional trust law and substitutes the concept of the security entitlement as a package of interests in common and personal rights derived from and exercisable exclusively against the holder's own intermediary through credits to a securities account, while at the same facilitating settlement finality through clear priority rules in favour of the bona fide purchaser for value who assumes control.

None of the interviewees sought to suggest that Article 8 is free from imperfections, but criticisms appeared to be directed more to some of the detailed workings of the rules than to Article 8's overall structure and content. The United States has now had a decade of experience with Article 8 and it is widely recognised as having made the market more efficient and workable. We have suggested in our Report that English law too does not need to be revolutionised and that a good deal of protection is already given to investors by well-established principles of trust law but that Article 8 is a pointer to the way in which our law can be improved, not by wholesale change but by adaptation of the existing rules to meet the legitimate needs of the modern market.

## SCHEDULE 1

### 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.

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
<p><b>1. Application</b></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><b>Article 8-102(a)(9) "Financial asset,"</b> except as otherwise provided in Section 8-103, means:</p> <ul style="list-style-type: none"> <li>(i) a security;</li> <li>(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</li> <li>(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.</li> </ul> <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><b>Article 8-102(a)(15) "Security,"</b> 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"> <li>(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;</li> <li>(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</li> <li>(iii) which: <ul style="list-style-type: none"> <li>(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or</li> <li>(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.</li> </ul> </li> </ul>
	<p><b>Article 8-102(a)(13) "Registered form,"</b> as applied to a certificated security, means a form in which:</p>

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
	<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><b>Article 8-102(a)(2) "Bearer form,"</b> 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><b>Article 8-102(a)(4) "Certificated Security"</b> means a security that is represented by a certificate.</p> <p><b>Article 8-501(a) "Securities account"</b> 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 comprise the financial asset.</p>
<p><i>Business only:</i> The principles do not apply to non-business arrangements.</p>	<p><b>Article 8-102(14) "Securities intermediary"</b> means:</p> <p>(i) a clearing corporation; or</p> <p>(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> <p><b>Article 8-501(b)</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><b>Article 1-102(3)</b> 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><b>2. Interests in Securities</b></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 securities". Interests in securities include</p>	<p><b>Article 8-102(17) "Security entitlement"</b> means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.</p> <p><b>Article 8-503(b)</b> An entitlement holder's property interest with respect to a particular financial asset ... is a pro rata property interest</p>

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
<p>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>in all interests in that financial asset held by the securities intermediary ...</p>
<p><b>3. Intermediary's duties:</b></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>(iii) The intermediary must ensure that securities held in the pool are sufficient securities to satisfy all clients' interests in securities.</p>	<p><b>Article 8-506</b> 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><b>Article 8-505(a)</b> 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><b>Article 8-505(b)</b> A securities intermediary is 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><b>Article 8-504</b> 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><b>Article 8-507</b> 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</p>

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
	<p>in accordance with reasonable commercial standards).</p> <p><b>Article 8-508</b> 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 the duty is discharged/due care in accordance with reasonable commercial standards).</p> <p><b>Article 8-509</b> 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><b>Article 8-503(c)</b> 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><b>Article 8-506</b> - see intermediary's duties above.</p> <p><b>Article 8-503(d)</b> 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"> <li>(1) insolvency proceedings have been initiated against the securities intermediary;</li> <li>(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;</li> <li>(3) the securities intermediary violated its obligations under Article 8-504 by transferring the financial asset or interest therein to the purchaser; and</li> <li>(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] ...</li> </ol> <p><b>Article 8-112(c)</b> The interest of a debtor in a 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</p>	

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
of third party claims.	
<p><b>4. Shortfalls</b></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><b>Article 8-503(b)</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><b>5. Insolvency Immunity</b></p> <p>Securities held by the client through an intermediary that are not available to the creditors of the intermediary.</p>	<p><b>Article 8-503(a)</b> To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary [except 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: <b>Article 8-511</b>]</p>
<p><b>6. The Attachment of Third Party Interests</b></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><b>7. The Perfection of Third Parties</b></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>[<b>Article 9-115(4)</b> 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)] [<b>Article 9.203</b>] a security interest is enforceable against the debtor and third parties</p>

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
	<p>with respect to the collateral only if:</p> <ul style="list-style-type: none"> <li>(1) Value has been given;</li> <li>(2) The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and</li> <li>(3) One of the following conditions is met: <ul style="list-style-type: none"> <li>(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;</li> <li>(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;</li> <li>(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</li> <li>(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 9-107 pursuant to the debtor's security agreement.</li> </ul> </li> </ul>
<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><b>Article 8-106(d)</b> A purchaser has "<b>Control</b>" 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.]<sup>5</sup></p> <p><b>Article 8-106(e)</b> 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><b>Article 8-106(f)</b> A purchaser who has satisfied these requirements has control even if the entitlement holder retains the right to make</p>

<sup>5</sup> This sub-paragraph was inserted by the 1998 revision of Article 9 with 2001 amendments.

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
	substitutions for the security entitlement, to originate entitlement orders to the securities intermediary, or otherwise to deal with the security entitlement.
<p><b>8. Priorities</b></p> <p>The following rules apply where there are competing claims to interests in securities.</p>	
<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><b>Article 8-115</b> 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"> <li>(1) took ... action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so...; or</li> <li>(2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or</li> <li>(3) in the case of a securities certificate that has been stolen, acted with notice of the adverse claim.</li> </ol>
<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><b>Article 9-206</b> 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><b>Article 9-328(c)</b> 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><b>Article 8-106(e)</b> (see definition of "Control" above).</p> <p>[<b>Article 8-510(d)</b> A securities intermediary as purchaser has priority over a conflicting purchaser who has control unless otherwise agreed by the securities intermediaries.]<sup>6</sup></p>
<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><b>Article 9-328</b> The following rules govern priority among conflicting security interests in the same investment property:</p> <ol style="list-style-type: none"> <li>(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 ...</li> <li>(b) conflicting security interests held by secured parties each of which has control ... rank according to priority in time of: <ol style="list-style-type: none"> <li>1) becoming the person for which the securities account is</li> </ol> </li> </ol>

<sup>6</sup> This provision was inserted by the 1998 revision of Article 9 with 2001 amendments.

PRINCIPLES FOR AN INVESTMENT SECURITIES STATUTE	UCC ARTICLE 8 (1994 REVISION)
	<p>maintained;</p> <p>2) the securities intermediary's agreement to comply with the secured party's entitlement orders; or</p> <p>3) if control is through another person, the time on which priority would be based if the other person were the secured party ...</p> <p>(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>(d) conflicting security interests created by a broker, securities intermediary ... which are perfected without control ... rank equally.</p> <p>(e) In all other cases, priority ... is governed [according to rules in <b>Article 9-322</b>].</p> <p><b>Article 9-322</b></p> <p>(1) Conflicting perfected security interests ... rank according to priority in time of filing or 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><b>Article 8-510(c)</b> 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 rank<sup>7</sup> 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><b>Article 8-116</b> 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</p>

<sup>7</sup> 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>entitlement to the financial asset in favour of an entitlement holder.</p> <p><b>Article 8-502</b> An action based on an adverse claim 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><b>Article 8-503(e)</b> 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><b>Article 8-510(a)</b> 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><b>Article 9-331(c)</b> 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><b>9. Set-Off</b></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 2**

### **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 most 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](http://www.assembly.state.ny.us/leg/?cl=122)

**FINANCIAL MARKETS LAW COMMITTEE**

[www.fmlc.org](http://www.fmlc.org)

**Telephone: (44 20) 7601 3918**

**Facsimile: (44 20) 7601 3865**

**Email: [fmlc@bankofengland.co.uk](mailto:fmlc@bankofengland.co.uk)**

**c/o BANK OF ENGLAND**

**Threadneedle Street**

**London**

**EC2R 8AH**

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**COMMITTEE MEMBERS**

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Bill Tudor John, Lehman Brothers

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