REPORT OF THE
JOINT SUBCOMMITTEE STUDYING

Proposed Modifications to the Uniform Commercial Code

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 84

COMMONWEALTH OF VIRGINIA
RICHMOND
1994

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**Report of the Joint Subcommittee Studying Proposed Modifications to the Uniform Commercial Code
To
The Governor and the General Assembly of Virginia
Richmond, Virginia
1994**

To: The Honorable George Allen, Governor,
and
the General Assembly of Virginia

I. INTRODUCTION

The 1993 General Assembly passed House Joint Resolution 524 (Appendix 1), continuing a joint subcommittee of the House of Delegates and the Senate reviewing proposed modifications to the Uniform Commercial Code. The joint subcommittee, composed of members from the House Committee on Corporations, Insurance and Banking and the Senate Committee on Commerce and labor, continued the work of its predecessors: examining revisions to the Uniform Commercial Code proposed by the National Conference of Commissioners on Uniform State Laws ("the Conference").

The following General Assembly members were appointed to the joint subcommittee: Delegates Heilig of Norfolk, Woodrum of Roanoke, Forbes of Chesapeake, and Finney of Rocky Mount, and Senators Holland of Arlington and Norment of Williamsburg. Delegate Heilig served as chairman of the joint subcommittee.

The joint subcommittee met in Richmond at the General Assembly Building on December 14, 1993. It received comments on the Conference's proposals to repeal or revise UCC Article 6, the Bulk Transfers Act, from Virginia's Commissioner to the Conference, and from the Chairman of the Virginia Bar Association's UCC Subcommittee. The Article 6 issue was before the joint subcommittee in 1992 when it recommended repeal. A repealer bill was introduced in the 1993 General Assembly session, but was not reported out of committee.

The HJR 524 joint subcommittee recommended that a repealer bill be introduced in the 1994 Session along with a bill substantially amending Article 6, the Conference's alternate proposal. The joint subcommittee concluded that both options should be presently to the General Assembly for its consideration.

The joint subcommittee also received a general overview of UCC Article 8 (Securities) revisions proposed by the Conference. Virginia's Commissioner to the Conference advised the joint subcommittee that the proposed revisions are intended to address an area of significant concern to the federal Securities and Exchange Commission (SEC). The SEC has reportedly indicated its intent, pursuant to the federal Market Reform Act of 1990 (prompted by the stock market crash of 1987 and the demise of Drexel Burnham, a major brokerage firm), to adopt regulations promoting uniform liquidity standards in securities sales clearance and settlement systems -- unless comparable uniform state laws are adopted.

The Article 8 drafting committee, slated to meet in January 1994, may have a draft ready for submission to the American Law Institute in May 1994. Thereafter, the draft will be considered by the Conference at its annual meeting in August 1994. The joint subcommittee was advised, however, that it is uncertain whether a Conference-approved draft will be ready for General Assembly action in 1995.

II. UCC ARTICLE 6; THE BULK TRANSFERS ACT

The Bulk Transfers Act (Va. Code § 8.6-101 et seq.) requires merchants to give notice to their creditors prior to selling their business inventory in a single transaction, i.e., a "bulk sale." Bulk sales frequently occur when a business is sold or discontinued. The Bulk Transfers Act ("the Act") is designed to discourage merchants from making bulk sales and failing to pay their creditors. The Act requires notice to creditors before such bulk sales are consummated, empowering creditors to void sales not conforming to the Act's requirements.

The Conference concluded that in today's commercial environment, the Act serves little useful purpose. Near-instantaneous credit checks assist manufacturers and other vendors in assessing the creditworthiness of merchants desiring to purchase business inventory on credit. Additionally, the widespread availability of "long arm" statutes and "uniform recognition of judgment" laws makes it virtually impossible, in most cases, for individuals intent upon defrauding creditors to use interstate movement as a means of evading state courts' jurisdiction or judgments.

Moreover, inventory financing under UCC Article 9 (Secured Transactions) may have displaced Article 6 as the protection of choice for manufacturers and wholesalers who sell inventory on credit. This attitude may be reflected in the decision of at least 16 other states to repeal Article 6. To date, a handful of states have taken the alternate route suggested by the Conference and adopted the Conference's Article 6 revision. A Conference position paper discussing the two options is attached as Appendix 2.

The UCC subcommittee of the Virginia Bar Association's Business Law section did not recommend the revision's adoption when Article 6 was examined by the joint subcommittee in 1992. The Bar committee reiterated its opposition to the revision before the 1993 joint subcommittee, recommending that the General Assembly repeal the article. A more extensive discussion of the Bar committee's position on this issue can be found in the 1992 joint subcommittee's final report (House Document 44 of 1993).

The joint subcommittee reviewed the following options: (i) making no change to existing law, (ii) adopting the Conference's revision to Article 6, or (iii) simply repealing Article 6 altogether. Unable to reach consensus, the joint subcommittee recommended that its staff prepare two bills for introduction in the 1994 Session of the General Assembly: one to repeal and one to amend.

III. UCC ARTICLE 8; SECURITIES.

According to the Conference, revisions to Article 8 are necessary because the article does not adequately deal with the system of securities holding through securities intermediaries that has developed in the past few decades. Article 8's provisions, to a large degree, correlate securities ownership with possession and delivery of actual share certificates. However, most securities transfers today are little more than accounting entries on the books of securities intermediaries, i.e., brokerages and depository institutions.

To bring Article 8 into the modern world of securities trading, the Conference's Article 8 revision incorporates a new concept known as "securities account entitlement" to draw together the rights of investors who hold securities indirectly through financial intermediaries. The draft describes the rights of holders of such "entitlements" and the obligations of financial intermediaries. In another significant revision, rules governing the creation and perfection of security interests in securities have been removed from Article 8 and placed in Article 9. Additionally, a new section has been added in Article 9 providing special priority rules for security interests in securities and securities account entitlements. A Conference summary of the Article 8 issues is attached as Appendix 3.

The Article 8 drafting committee, slated to meet in January 1994, expects to have a draft ready for approval by the American Law Institute in May 1994. Thereafter, it is expected the draft will be considered by the Conference at its annual meeting in August 1994. It could not be determined at the time of the joint subcommittee's meeting whether a Conference-approved draft would be ready for General Assembly action at the 1995 Session.

IV. CONCLUSION

The joint subcommittee had no further business before it and, accordingly, directed that its recommendations and proceedings in 1993 be reported to the Governor and the 1994 Session of the General Assembly.

V. APPENDIX

1. House Joint Resolution No. 524
2. Summary: Revision or repeal of UCC Article 6; Bulk Sales
3. Summary Revised UCC Article 8; Investment Securities

GENERAL ASSEMBLY OF VIRGINIA--1993 SESSION

HOUSE JOINT RESOLUTION NO. 524

Continuing the Joint Subcommittee Studying Proposed Modifications to the Uniform Commercial Code.

Agreed to by the House of Delegates, February 7, 1993
Agreed to by the Senate, February 23, 1993

WHEREAS, the Uniform Commercial Code has been adopted in 49 states, the District of Columbia, and the Virgin Islands; and

WHEREAS, the National Conference of Commissioners on Uniform State Laws has adopted revisions to various articles of the U.C.C. and is considering additional revisions to update the U.C.C.; and

WHEREAS, the 1988, 1989, 1990 and 1992 Sessions of the General Assembly, pursuant to House Joint Resolutions 59, 248, 15 and 147, respectively, established and continued a joint subcommittee to study U.C.C. modifications proposed by the National Conference; and

WHEREAS, the joint subcommittee recommended adoption of new U.C.C. articles and revisions to existing articles, and such recommendations were enacted by recent sessions of the General Assembly; and

WHEREAS, the National Conference continues to develop revisions to existing articles, responding frequently to changes in commercial practices, technological innovations, and evolving regulatory practices; and

WHEREAS, the National Conference's revision of U.C.C. Article 8 (investment securities) will be available for legislative review and study in June 1993; and

WHEREAS, the need for continued uniformity in the area of commercial law is great; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Joint Subcommittee Studying Proposed Modifications to the Uniform Commercial Code proposed by the National Conference be continued.

The joint subcommittee's current membership shall continue to serve. Vacancies shall be filled by the Speaker of the House or the Senate Committee on Privileges and Elections, as appropriate. The business law sections of the State Bar of Virginia and the Virginia Bar Association are requested to assist in the study.

The indirect costs of this study are estimated to be $5,860; the direct costs of this study shall not exceed $1,800.

Implementation of this resolution is subject to subsequent approval and certification by the Joint Rules Committee. The Committee may withhold expenditures or delay the period for the conduct of the study.

UNIFORM COMMERCIAL CODE
REVISED ARTICLE 6 — BULK SALES

—A Summary —

Article 6 of the Uniform Commercial Code (UCC) provides a specific kind of protection for creditors of businesses that sell merchandise from stock. Creditors of these business are vulnerable to a "bulk sale", in which the business sells all or a large part of inventory to a single buyer outside the ordinary course of business, following which the proprietor absconds with the proceeds. Original Article 6 of the UCC requires "bulk sale" buyers to provide notice to the seller's creditors and to maintain a list of seller's creditors and a schedule of property obtained in a "bulk sale" for six months after the "bulk sale" takes place. Unless these procedures are followed, creditors may void the sale. Auctioneers, who handle merchandise in bulk, are given a similar burden to that of "bulk sale" buyers.

Article 6 replaced a variety of earlier bulk sales laws in the states. All were enacted in a climate of smaller businesses that were localized in scope. These laws protected local business creditors from liquidations that might take merchandise and proceeds beyond these creditors' ability to obtain a remedy. Article 6 introduced the salubrious quality of uniformity to these protections for creditors.

But the credit environment has changed, so that the risk of the absconding merchandiser is no longer very great. Business creditors can evaluate creditworthiness far better than was the case when the UCC was first promulgated, and they can pursue absconding sellers with much less difficulty. Further, modern fraudulent transfer actions under the Uniform Fraudulent Transfer Act overlap Article 6 in a significant way. Sophisticated and widespread inventory financing under Article 9 of the UCC, which provides even more significant protections for creditors, simply by-passes Article 6 protections. In 1988, as revisions of Article 6 were being considered, a considerable body of opinion supported the notion of repeal for Article 6. That body of opinion perceived that the balance of equities had swung from essential protection for creditors to unnecessary burden for "bulk sale" buyers.

It was not clear, however, that repeal was or is a uniform solution or a uniformly acceptable recommendation in every state and jurisdiction. So the Revised Article 6 of the UCC is provided in the alternative. Alternative A offers the states the option of repealing the whole of Article 6. Alternative B offers a revised and updated Article 6 to those states and jurisdictions that will evaluate the positions of creditors, sellers, and buyers, and then decide to retain a bulk sales law.

How is uniformity to be served and maintained when states are given these alternatives? The law of the seller's place of business controls the choice of law. If the seller in a bulk sale has his or her place of business in a state in which Article 6 has been repealed, then there is no bulk sales law applicable to the sale. If the state does have Revised Article 6, it applies. No conflict situation should arise.

Revised Article 6, if repeal is not chosen, remedies the problems of the original. It minimizes the burdens placed upon the bulk sale buyer. The object is to pinpoint the creditor's risk and to narrow the reach of the statute to cover that risk and no more. Much improvement accrues through the definitions of such terms as "assets", "bulk sale", "date of bulk sale", and the like, all of which increase the certainty of Revised Article 6. None of these terms are defined at all in the original Article 6. A "bulk transfer" under original Article 6 took place with the transfer "of a major part of the materials, supplies, merchandise or other inventory" outside the ordinary course of business. Revised Article 6 defines "assets" as "inventory that is subject of a bulk sale and any tangible and intangible personal property used or held for use primarily in, or arising from, the seller's business and sold in connection with that inventory. .." The reach of Article 6 is more clearly confined in Revised Article 6.

In Revised Article 6 a "bulk sale" takes place if there is a sale of "more than half the seller's inventory" outside the ordinary course of business and under conditions in which the "buyer has notice. . .that the seller will not continue to operate the same or a similar kind of business after the sale". Again the reach of Article 6 is limited and more clearly defined than under the original Article 6. The risk to creditors arises from the sale in which the seller goes out of business, so Revised Article 6 applies only to those situations.

The notion of limitations is carried forward in the extended exceptions provision in Revised Article 6. Certain kinds of transfers are excepted under original Article 6. Any transfer that secures an obligation or that is accomplished to satisfy an obligation is not subject to original Article 6. A sale or transfer of a business that preserves existing creditors' rights is not subject to original Article 6. Revised Article 6 improves upon the existing exceptions with some new notice requirements for buyers who will assume the seller's debts.

Revised Article 6, also, excepts for the first time any asset sales that fall below a net value of $10,000.00 or that exceed a value of $25,000,000.00. In neither case is there a perceived need to burden the buyer with the requirements of Article 6. The small amounts constitute a nuisance, and the very large "bulk sale" can hardly be done in a manner unknown to creditors and, indeed, to the world.

What a buyer in a bulk sale does under Revised Article 6 is primarily the same as what that buyer does under original Article 6. The buyer obtains a list of creditors ("claimants" under Revised Article 6) and provides them with notice of the "bulk sale". The notice requirements are different, however, under Revised Article 6. If the seller provides a list of 200 or more claimants, or provides a verified statement that there are more than 200, the buyer satisfies the notice requirement by filing a written notice of the "bulk sale" with the office of the Secretary of State (or other applicable official, as a state provides) rather than by giving written notice to all claimants. One of the great burdens to buyers under original Article 6 is individual notice to large numbers of creditors. Revised Article 6 simplifies the process.

Revised Article 6, also, provides for a different array of information that is kept for creditors (or claimants). Under original Article 6, the buyer kept a schedule of property and a list of claimants for a six month period following the sale. These are not requirements of Revised Article 6. Instead, the seller and buyer must agree on the net contract price to be distributed, and then must set forth "a written schedule of distribution". The "schedule of distribution" may provide for any distribution that the seller and buyer agree to, "including distribution of the entire net contract price to the seller." The schedule of distribution accompanies any notice given to claimants, however given.

The last significant change from the original Article 6 in Revised Article 6 is the basic remedy available to creditors. In original Article 6, the creditor voids the sale. Revised Article 6 provides for money damages rather than for voiding the sale. The creditor is entitled to damages for noncompliance in an amount to equal his or her real losses. There are cumulative limits on the damages that may be assessed, and buyers are given the defense of "good faith" efforts to comply with Article 6.

Auctioneers and liquidators continue to be covered by Revised Article 6. Those who conduct auction sales and liquidation sales are treated as "bulk sale" buyers, and must provide notice to claimants as "bulk sale" buyers are required to do. The notice form is different and tailored to auction or liquidation sales.

Revised Article 6 extends the statute of limitations on creditor's actions from six months to one year. Original Article 6 provided for six months. The period runs from the date of the "bulk sale". Concealed sales toll the statute of limitations in Revised Article 6, as they do under original Article 6.

Repeal or revise are the options offered to the states in the Revised Article 6 of the UCC. Repeal is the preferred option, but the revisions in Alternative B eliminate the significant difficulties encountered under original Article 6, and make them an excellent alternative to repeal.

Why states should revise Article 6 of the Uniform Commercial Code

Bulk sales laws were originally drafted in response to a fraud perceived to be common around the turn of the century: a merchant would acquire his stock in trade on credit, then sell the entire inventory ("in bulk") and abscond with the profits, leaving creditors unpaid.

Article 6 was drafted as a response to this "bulk sale risk." It affords creditors a remedy against a good faith purchaser for full value without notice of any wrongdoing on the part of the seller. In the legal context in which Article 6 was drafted, the benefits to creditors appeared to justify the costs of interfering with good faith transactions.

Present Article 6 imposes several duties on the buyer in bulk. These duties include the duty to notify the creditors of the impending bulk transfer. This can be burdensome, particularly when the seller has a large number of creditors.

The Article requires compliance even when there is no reason to believe that the seller is conducting a fraudulent transfer, as when the seller is scaling down the business but remaining available to creditors. And it also imposes strict liability for noncompliance. Failure to comply with the provisions of the Article renders the transfer ineffective, even when the buyer has complied in good faith, and even when no creditor has been injured by the noncompliance.

The current revision of Article 6 is designed to reduce the burdens and risks imposed upon good-faith buyers of business assets while increasing the protection afforded to creditors.

Among the needed changes are:

— Article 6 applies only when the buyer has notice that the seller will not continue to operate the same or a similar kind of business after the sale;

— when the seller is indebted to a large number of creditors, the buyer does not have to send individual notice to every person, but instead may give notice by filing;

— a buyer who makes a good faith effort to comply with the requirements of Article 6 is not liable for noncompliance.

Present Article 6 has become inadequate to regulate modern bulk sales. The revised Article is designed to afford better protection to creditors while minimizing the impediments to good-faith transactions.

Why states should repeal Article 6 of the Uniform Commercial Code

Bulk sales laws were originally drafted in response to a fraud perceived to be common around the turn of the century: a merchant would acquire his stock in trade on credit, then sell his entire inventory ("in bulk") and abscond with the proceeds, leaving creditors unpaid.

Article 6 was drafted as a response to this "bulk sale risk." It imposes several duties on the buyer in bulk, including the duty to notify all creditors of the impending bulk transfer. It also requires compliance even when there is no reason to believe that the seller is conducting a fraudulent transfer. The Article imposes strict liability for noncompliance. Failure to comply with the provisions render the transfer ineffective, even when the buyer has complied in good faith.

But today, changes in the business and legal contexts in which sales are conducted have made regulation of bulk sales unnecessary. Creditors are better able to make informed decisions about whether to extend credit. Changes in technology have enabled credit reporting services to provide fast, accurate, and more complete credit histories at relatively small cost.

Creditors also have greater opportunity to collect their debts. The adoption of state long-arm statutes and rules have greatly improved the possibility of obtaining personal jurisdiction over a debtor who flees to another state.

And creditors no longer face the choice of extending unsecured credit or no credit at all. Retaining an interest in inventory to secure its price has become relatively simple and inexpensive under Article 9 of the UCC - adopted in 49 states. If a bulk sale is fraudulent and the buyer is a party to the fraud, creditors have remedies under the Uniform Fraudulent Transfer Act.

There is no evidence that in today's economy, fraudulent bulk sales are frequent enough, or engender credit losses significant enough, to require regulation of all bulk sales, including the vast majority that are conducted in good faith.

The Uniform Law Commissioners, therefore, encourage those states that have enacted Article 6 to repeal it.

UNIFORM COMMERCIAL CODE
REVISED ARTICLE 8. INVESTMENT SECURITIES

PREFATORY NOTE

I. HISTORY OF THE ARTICLE 8 REVISION

A. Drafting History

In the Spring of 1991, the National Conference of Commissioners on Uniform State Laws formed a Drafting Committee to Revise Uniform Commercial Code Article 8—Investment Securities. The current project to revise Article 8 comes in response to expressions of concern from various sources that the present structure of Article 8 may be inadequate to deal with recent developments in securities holding and trading practices.

In several of the studies issued after the October 1987 stock market break, it was suggested that uncertainties about the application of the Article 8 rules to securities held through intermediaries, particularly the rules governing perfection of security interests in securities so held, might have adversely affected the willingness of financial institutions to provide essential financing to securities firms in periods of market disturbance. At the suggestion of the Securities and Exchange Commission, the Business Law Section of the ABA formed an Advisory Committee on Settlement of Market Transactions to undertake a study of possible revisions of Article 8 and related provisions of bankruptcy law. In February of 1991 the ABA Committee issued an Interim Report, making tentative recommendations for revision of Article 8 and various provisions of the federal Bankruptcy Code.

At the same time that the ABA Committee was at work, Congress was considering various legislative packages for amendments to the securities laws in response to the October 1987 market break and the failure of Drexel Burnham in February of 1990. Included in the legislation adopted as the Market Reform Act of 1990, P.L. 101-432, was a provision, codified at 15 U.S.C. 78q-1(f), giving the Securities and Exchange Commission the authority to promulgate regulations preempting state law on the "transfer of certificated or uncertificated securities ... or limited interests (including security interests) therein; and the rights and obligations of purchasers, sellers, owners, lenders, borrowers, and financial intermediaries (including brokers, dealers, banks, and clearing agencies) involved in or affected by such transfers, and the rights of third parties whose interests in such securities devolve from such transfers." The Act, however, provides that the SEC is to act only if it makes certain specified findings, after recommendations of an Advisory Committee and consultation with the Secretary of the Treasury and Board of Governors of the Federal Reserve System, to the effect that the absence of a uniform federal rule substantially impedes the safe and efficient operation of the national system for clearance and settlement of securities transactions. There is also a provision in the Act, 15 U.S.C. § 78q-1(f)(3), apparently added late in the legislative process, specifying that if the SEC promulgates such rules, a State can effectively "opt-out" by enacting legislation establishing rules differing from the federal rules.

In response to these developments, the Executive Committee of the National Conference of Commissioners on Uniform State Laws decided in the Spring of 1991 to form a Drafting Committee and directed the Committee to proceed as quickly as possible with the work of revising Article 8 to meet the needs identified in these various studies. The Drafting Committee has had numerous meeting since the Fall of 1991 to discuss drafts of Revised Article 8. A full draft was presented for a first reading at the Annual Meeting of the National Conference in August 1992. The American Law Institute has also begun the process of consideration of the draft, through a Members Consultative Group and an Ad Hoc Committee formed by the ALI Council, and draft will be presented to the ALI membership at the May 1993 meeting.

Because the Drafting Committee has been able to proceed rapidly toward promulgation of revised Article 8, and relevant provisions of Article 9, it appears that the goal of resolving the present problems within the framework of the Uniform Commercial Code is within reach. The two key bodies with authority to promulgate separate bodies of commercial law rules for particular sectors of the market -- the SEC and the United States Treasury -- are following the Article 8 project closely. If the Article 8 project continues to progress rapidly, there is every reason to believe that neither the SEC nor the Treasury will find it necessary to exercise their authority to pre-empt state law. Although the SEC Market Transactions Advisory Committee ("MTAC") is actively at work on studying a broad range of legal issues concerning securities clearance and settlement, while the Article 8 project is proceeding MTAC has decided to focus on revisions that might be needed in federal law, or other regulatory action that might be appropriate pending or even after a comprehensive revision of UCC Article 8. Many of the members of MTAC, including its chair and principal SEC representative, are also acting as advisors to the NCCUSL Drafting Committee. The U.S. Department of the Treasury has for some years been considering promulgation of revised regulations (the "TRADES" regulations) governing the book-entry system for federal government securities. Representatives of the Treasury and the Federal Reserve system have been working closely with the NCCUSL Drafting Committee from the beginning of the project, and have indicated that they share the hope of the Drafting Committee that revised Article 8 could provide a sound basis for the government securities market, so that it would not be necessary for federal regulations to establish a separate system of commercial law for government securities. On another front, it should be noted that representatives of the commodities industry and the CFTC have also been working closely with the revision project. The current draft implements the consensus reached in several meetings with the commodities representatives that although commodity futures contracts and commodity options should not be governed by Article 8, the new Article 9 security interest rules on security interests in securities should also apply to commodities, with some modifications.

The Drafting Committee and the Reporter have made special efforts to reach out to groups with interests in the matters covered by Article 8 both to learn the problems and needs of the securities business and to explain to the industry and the bar the approach taken in Revised Article 8. The Reporter has met with individual securities firms, banks involved in securities clearance, custody, and processing, domestic and foreign clearing corporations, mutual funds, transfer agents, and lenders to securities firms, as well as with industry organizations, including the Securities Industries Association, the Public Securities Association, the Securities Transfer Association, and the Investment Company Institute, and the New York Clearing House. Representatives of the relevant regulatory and other governmental agencies, including the SEC, the CFTC, and the Federal Reserve Banks, and the Treasury Department, have been following and participating in the project. Contacts have also been established with representatives of the U.S. Working Committee of the Group of Thirty, an independent non-partisan, non-profit organization which is working with the industry to implement improvements in the clearance and settlement systems for securities trading in the United States and globally. The Reporter and others have also made presentations on the revision project at meetings of the American Bar Association, the Association of American Law Schools, various state and local bar associations and numerous continuing legal education programs. The project has also been publicized in the relevant periodicals, including the Business Lawyer, the UCC Bulletin, the Commercial Law Annual, and the ABA UCC Committee newsletter. As a result of these outreach efforts, the revision project has probably received as much or more attention as similar projects in recent years, despite the fact that it is proceeding on a relatively fast track.

The Reporter wishes to express gratitude to many within the industry who have been generous with their time in answering questions and assisting the Reporter and Drafting Committee in learning about the clearance and settlement system. Any errors or inaccuracies in the description of securities practices contained in this draft are the Reporter's responsibility. The Reporter welcomes correction on such matters.

B. Need for Revision of Article 8 - Evolution of Securities Holding and Trading Systems

The principal reason that revision of Article 8 is necessary is that present law does not adequately deal with the system of securities holding through securities intermediaries that has developed in the past few decades. Although present Article 8 does contain some provisions dealing with securities holding through securities intermediaries, these have been engrafted onto a structure designed for securities practices of earlier times. The resulting legal uncertainties adversely affect all participants. The revision seeks to provide a modern legal structure for current securities holding practices.

1. The Traditional Securities Holding System

The original version of Article 8 of the UCC is based on the assumption that possession and delivery of physical certificates are the key elements in the securities holding and trading system. Ownership of securities was traditionally evidenced by possession of the certificates, and changes were accomplished by delivery of the certificate.

The traditional certificate-based system of securities transfers was a complicated, labor-intensive process. Each time securities were traded, the physical certificates had to be delivered from the seller to the buyer, and in the case of registered securities, the certificates had to be surrendered to the issuer or its transfer agent for registration of transfer. As is well known, the mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960s, leading to calls for the elimination of the physical certificate and development of modern electronic systems for recording ownership of securities and transfers of ownership. That was the focus of the revision effort that lead to the promulgation of the 1978 amendments to Article 8 concerning uncertificated securities.

2. The Uncertificated Securities System Envisioned by the 1978 Amendments

In 1978, amendments to Article 8 were approved to establish the commercial law rules that were thought necessary to permit the evolution of a system in which issuers would no longer issue certificates. The Drafting Committee that produced the 1978 amendments was given a fairly limited charge. It was to draft the revisions that would be needed for uncertificated securities, but otherwise leave the Articles 8 rules unchanged. Accordingly, the 1978 amendments primarily took the form of adding parallel provisions dealing with uncertificated securities to the existing rules of Article 8 on certificated securities.

The system of securities holding and trading contemplated by the 1978 amendments differed from the traditional system only in that ownership of securities would not be evidenced by physical certificates. It was contemplated that changes in ownership would continue to be reflected by changes in the records of the issuer. The main difference would be that instead of surrendering an indorsed certificate for registration of transfer, an instruction would be sent to the issuer directing it to register the transfer. Although a system of the sort contemplated by the 1978 amendments may well develop in the coming decades, this has not yet happened for most categories of securities. Virtually all publicly traded corporate and municipal securities are still issued in certificated form. Individual investors who wish to be recorded as registered owners on the issuer's books still obtain and hold physical certificates. The certificates representing the largest portion of the shares, however, are not held by the beneficial owners, but by clearing corporations. Settlement of securities trading occurs not by delivery of certificates or by registration of transfer on the records of the issuers or their transfer agents, but by notation on the records of clearing corporations and securities intermediaries. That is quite different from the system envisioned by the 1978 amendments.

3. Evolution of the Indirect Holding System

At the time of the "paperwork crunch" in the late 1960s, the trading volume on the New York Stock Exchange that so seriously strained the capacities of the clearance and settlement system was in the range of 10 million shares per day. Today, the system can easily handle daily trading volume on routine days in the range of 150 to 200 million shares. Even during the October 1987 market break, when daily trading volume reached the current record level of 608 million shares, the clearance and settlement system functioned relatively smoothly. Obviously this processing capacity could have been achieved only by the application of modern electronic information processing systems, and that is the case. Physical delivery of certificates plays only a minor role in the settlement system that processes this enormous volume of securities trading. Yet the legal rules under which the system operates are **not** the uncertificated securities provisions of Article 8. To understand why this is so, one must delve at least a bit deeper into the operations of the current system.

If one examined the shareholder records of any large corporation whose shares are publicly traded on the exchanges or over the counter market, one would find that one entity -- Cede & Co. -- is listed as the shareholder of record of somewhere in the range of sixty to eighty per cent of the outstanding shares of all publicly traded companies. Cede & Co. is the nominee name used by The Depository Trust Company ("DTC"), a limited purpose trust company organized under New York law for the purpose of acting as a depository to hold securities for the benefit of its participants, some 600 or so broker-dealers and banks. Essentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in DTC, and the great bulk of public securities -- the sixty to eighty per cent figure noted above -- are held in the names of these broker-dealers and banks on behalf of their customers. If all of these broker-dealers and banks held their securities themselves, then as trades were executed each day it would be necessary to transfer the securities back and forth among these broker-dealers and banks. By handing all of their securities over to a common depository all of these deliveries can be eliminated. DTC's books break down the total number of shares of each security that it holds in the aggregate into accounts for each of its participants. All that needs to be done to settle each day's trading is for DTC to adjust the amounts shown in the participants' accounts.

Although the use of a common depository eliminates the needs for physical deliveries, an enormous number of entries would still have to be made on DTC's books if each transaction between its participants were recorded one by one on DTC's books. Any two major broker-dealers may have executed hundreds or even thousands of trades with each other in a given security on a single day. Significant processing efficiency has been achieved by netting all of the transactions among the major players that occur each day, so that entries need be made on the depository's books only for the net changes in the positions of each participant at the end of each day. This netting function might well be performed by the securities exchanges or by the same institution that acts as the depository, as is the case in many other securities markets around the world. In the United States, however, this clearance function is carried out by a separate corporation, the National Securities Clearing Corporation (NSCC).

The broker-dealers and banks who are participants in the DTC-NSCC system in turn provide analogous clearance and settlement functions to their own customers. If Customer A buys 100 shares of XYZ Co. through Broker, and Customer B sells 100 shares of XYZ Co. through the same Broker, the trade can be settled solely by entries on Broker's books. Neither DTC's books showing Broker's total position in XYZ Co., nor XYZ Co.'s books showing DTC's total position in XYZ Co., need be changed to reflect the settlement of this trade. One can readily appreciate the significance of the settlement function performed at this level if one considers that a single major bank may be acting as securities custodian for hundreds or thousands of mutual funds, pension funds, and other institutional investors. On any given day, the customers of that bank may have entered into an enormous number of trades, yet it is possible that relatively little of this trading activity will result in any net change in the custodian bank's positions on the books of DTC.

Settlement of market trading in most of the major securities markets is now effected primarily through some form of depository system. Virtually all publicly traded corporate equity securities, corporate debt securities, and municipal debt securities are now eligible for deposit in the DTC system. Recently, DTC has implemented a similar depository settlement system for the commercial paper market, and could, but for limitations in present Article 8, handle other forms of short-term money market securities such as bankers acceptances. For trading in mortgage-backed securities, such as Ginnie Mae's, a similar depository settlement system has been developed by the Participant's Trust Company. For trading in U.S. Treasury securities, a system somewhat analogous to the DTC depository system was put into place by the Treasury and the Federal Reserve System in the mid-1970s. Treasury securities are genuinely "uncertificated," that is, no paper certificates are issued. The holding system for Treasury securities, however, bears more resemblance to the DTC depository system than to the uncertificated system envisioned by the 1978 amendments to Article 8. In the Treasury system as in the DTC system, the records of ownership are maintained through a tiered system, rather than on a single set of records maintained by or on behalf of the issuer. The Federal Reserve Banks, acting as fiscal agent for the Treasury, maintain records of the holdings of member banks of the Federal Reserve System, and those banks in turn maintain records showing the extent to which they are holding for their own customers, including government securities dealers, institutional investors, or smaller banks who in turn act as custodians for investors.

4. Need for Different Legal Rules for the Direct and Indirect Holding Systems

Both the traditional paper-based system, and the uncertificated system contemplated by the 1978 amendments, can be described as "direct" securities holding systems, that is, the beneficial owners of securities have a direct relationship with the issuer of the securities. For certificated securities in bearer form, whoever has possession of the certificate thereby has a direct claim against the issuer. For registered securities, the registered owner, whether of certificated or uncertificated securities, has a direct relationship with the issuer by virtue of being recorded as the owner on the records maintained by the issuer or its transfer agent.

By contrast, the DTC depository system for corporate equity and debt securities, or the Treasury-Federal Reserve system for government securities, can be described as "indirect holding" systems, that is, the issuer's records do not show the identity of all of the beneficial owners. Instead, a large portion of the outstanding securities of any given issue are recorded on the issuer's records as belonging to a depository. The depository's records in turn show the identity of the banks or brokers who are its members, and the records of those securities intermediaries show the identity of their customers.

Even after the 1978 amendments, the rules of Article 8 do not deal effectively with the indirect holding system. The rules of Article 8 are based on the assumption that changes in ownership of securities are effected in either or both of two ways: delivery of physical certificates or registration of transfer on the books of the issuer. Yet in the indirect holding system, settlement of the vast majority of securities trades does not involve either of these events. For most, if not all, of the securities held through DTC, physical certificates representing DTC's total position do exist. These "jumbo certificates," however, are never delivered from person to person. Just as nothing ever happens to these certificates, virtually nothing happens to the official registry of stockholders maintained by the issuers or their transfer agents to reflect the great bulk of the changes in ownership of shares that occur each day.

The principal mechanism though which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but accounting entries on the books of a multi-tiered pyramid of securities intermediaries through which investment securities are held. Herein in the basic problem. Virtually all of the rules of Article 8 specifying how change in ownership of securities are effected, and what happens if something goes awry in the process, are keyed to the concepts of a transfer of physical certificates or registration of transfers on the books of the issuers; yet that is not hów changes in ownership are actually reflected in the modern securities trading system.

II. SUMMARY OF REVISED ARTICLE 8

A. Drafting Approach

One of the challenges that the Drafting Committee faces in this project is devising a structure of commercial law rules for investment securities that will be sufficiently flexible to respond to changes in practice over the next few decades. If it were possible to predict with confidence how the securities holding and trading system would develop, the Committee could produce a statute designed specifically for the system envisioned. Recent experience, however, shows the danger of that approach. The 1978 amendments to Article 8 were based on the assumption that the solution to the problems that plagued the paper-based securities trading system of the 1960s would be the development of uncertificated securities. Instead, the solution thus far has been the development of the indirect holding system.

If one thought that the indirect holding system would come to dominate securities holding, one might draft Article 8 rules designed primarily for the indirect holding system, giving limited attention to the traditional direct holding system of certificated securities or any uncertificated version of a direct holding system that might develop in the future. It is, however, by no means clear whether the long-term evolution will be toward decreased or increased use of direct holdings. At present investors in most equity securities can either hold their securities through brokers or request that certificates be issued in their own name. For the immediate future it seems likely that that situation will continue. One can imagine many plausible scenarios for future evolution. Direct holding might become less and less common as investors become more familiar and comfortable with book-entry systems and/or as market or regulatory pressures develop that discourage direct holding. One might note, for example, that major brokerage firms are beginning to impose fees for having certificates issued and that some observers have suggested that acceleration of the cycle for settlement of securities traders might be facilitated by discouraging customers from obtaining certificates. On the other hand, other observers feel that it is important for investors to retain the option of holding securities in certificated form, or at least in some form that gives them a direct relationship with the issuer and does not require them to hold through brokers or other securities intermediaries. Some groups within the securities industry are beginning to work on development of uncertificated systems that would preserve this option.

The Drafting Committee has adopted a position of neutrality toward the evolution of securities holding practices. The Committee has proceeded on the assumptions that path of development will be determined by market and regulatory forces and that the Article 8 rules should not seek to influence that development in any specific direction. In some respects, this makes the drafting task that the Committee faces more challenging. Rather than writing rules for any one particular securities holding system, the Committee has attempted to devise a structure that will continue to provide an adequate legal foundation for all of the securities holding systems now in use, and those that might evolve in the coming years. This approach does generate some complexity, but there seems to be no alternative that would avoid the risk of immediate obsolescence.

The principle of neutrality does carry some implications for the design of specific Article 8 rules. The Committee has attempted to identify and eliminate any Article 8 rules that might act as impediments to any of the foreseeable paths of development. At the very least, the Article 8 rules for all securities holding systems should be sufficiently clear and predictable that uncertainty about the governing law does not itself operate as a constraint on market developments.

Although the Drafting Committee and Reporter considered various approaches to drafting a system of rules that could accommodate the variety of securities holding systems in use today, it became apparent early in the process that the differences between the direct holding system and the indirect holding system are sufficiently significant that it is best to treat them as separate systems requiring different legal concepts. Accordingly, while the rules of present Article 8 have, in large measure, been retained for the direct holding system, a new Part 5 has been added, setting out the commercial law rules for the indirect securities holding system.

In addition to the changes in Article 8 itself, the statutory provisions on security interests in investment securities have been substantially revised. Thus, there are significant revisions in Article 9 as well as Article 8. The rules on security interests in investment securities have been taken out of Article 8 and placed in Article 9. This is a return to the organizational pattern of the pre-1978 UCC, which many commentators have recommended.

B. Direct Holding System

With respect to securities held directly, Revised Article 8 retains the basic conceptual structure and rules of present law. Thus, two significant categories of securities transactions will be relatively unaffected by the revision: (1) transactions involving securities issued by close corporations and (2) transactions in publicly traded securities held by investors who choose to hold their own securities, registered in their own names, rather than leaving them with their brokers or bank custodians. There are some changes in the organization of the provisions of existing law for the direct holding system, and some changes in substantive rules, but these changes are far less extensive than the revisions affecting the indirect holding system. The change that is probably most significant for securities held in the direct holding system is the revision of the rules on security interests. Even here, however, the Committee has endeavored to draft the new rules in such fashion that existing practices can be continued. The changes either provide additional methods of implementing secured transactions or facilitate transactions that are currently difficult to carry out.

C. Indirect Holding System

1. How Present Law Treats the Indirect Holding System

The basic concepts of the present Article 8 rules are that an investor is treated as the owner of a security, and changes in ownership are described as transfers of a property interest in the security from the transferor to the transferee. The provisions of present law that deal with the indirect holding system endeavor to fit it into the same conceptual structure. A good example is the basic legal rule under which the depository system operates, Section 8-320 of present law. Section 8-320 was added to Article 8 in 1962, at the very end of the process that culminated in promulgation and enactment of the original version of the Code, to take account of the depository system that was then in its infancy. The key concepts of the original version of Article 8 were "bona fide purchaser" and "delivery." Under Section 8-302 (1962) one could qualify as a "bona fide purchaser" only if one had taken a delivery of securities, and Section 8-313 (1962) specified what counted as a delivery. Section 8-320 was added to take account of the fact that in a depository system, no actual deliveries occur in settlement of trades. Rather than reworking the basic concepts, however, Section 8-320 brought the depository system within Article 8 by definitional fiat. Subsection (a) of UCC § 8-320 (1962) stated that a transfer or pledge could be effected by entries on the books of a central depository, and subsection (b) stated that such an entry "has the effect of a delivery of a security in bearer form or duly indorsed in blank." In 1978, Section 8-320 was revised to conform it to the general substitution of the concept of "transfer" for "delivery," but the basic structure remained the same. Under the 1978 version of Section 8-320, a change in ownership of securities held through a clearing corporation is treated as a transfer of the security from one person to another, and the main point of Section 8-320 is to ensure that making appropriate entries on the books of a clearing corporation has the effect of transferring an interest in the security.

In the 1978 amendments, other provisions were added to deal with the indirect holding system at the level below the securities depositories. The most important was Section 8-313(1)(d). Section 8-313 of the 1978 version of Article 8 sets out an exclusive list of the means by which an interest in a security can be transferred. Subsection (1)(d) of Section 8-313 is the provision dealing with investors who hold securities through a brokers or bank custodians. It operates in essentially the same fashion as Section 8-320, that is, it states that when a broker or bank which holds securities in fungible bulk makes entries on its books identifying a quantity of the fungible bulk as belonging to the customer, that action has the effect of transferring an interest in the security to the customer.

2. How Revised Article 8 Treats the Indirect Holding System

The starting point of Revised Article 8's treatment of the indirect holding system is the concept of "securities entitlement." The term is defined in Section 8-102(a)(16) as the package of rights that a person who holds securities through a securities intermediary has against that securities intermediary and the property held by that securities intermediary. The term "entitlement holder" is used to refer to a person who has a securities entitlement.

Structurally, the term "securities entitlement" is the analog for the indirect holding system of the term "security" for the direct holding system. The property interest of an investor who holds directly is a "security;" the property interest of an investor who holds in indirect form is a "securities entitlement." Like many legal concepts, however, the meaning of "securities entitlement" is to be found less in any specific definition than in the matrix of rules that use the term. In a sense, then, the entirety of Part 5 is the definition of "securities entitlement," because the Part 5 rules specify the rights of those who hold securities entitlements.

Part 5 begins by specifying, in Revised Section 8-501, when an entitlement holder acquires a securities entitlement. Revised Section 8-501 takes the place of Section 8-313(1)(d) of present law, but is based on a different analysis of the transaction in which a customer acquires an interest in the indirect holding system. Under present law, the investor is treated as a purchaser to whom an interest in a security is transferred when the securities intermediary makes entries on its books reflecting that a quantity of securities held by the securities intermediary in fungible bulk now belong to the customer. Revised Section 8-501 takes a different approach. The transaction is not described as a "transfer" of an interest in some portion of a fungible bulk of securities held by the securities intermediary, but as the creation of a package of rights against the securities intermediary, and an interest in the property held by the securities intermediary.

The remaining sections of Part 5 specify the content of the securities entitlement concept. The Part 5 rules provide that a securities intermediary must maintain a sufficient quantity of securities or securities entitlements to satisfy all of its entitlement holders, and that to this extent the securities or securities entitlements are held by the intermediary for the entitlement holders and are not subject to general creditors claims. Thus, a securities entitlement is not merely an in personam claim against the intermediary. The concept of a securities entitlement does, however, include a package of in personam rights against the intermediary, and other Part 5 rules specify the core of this package of rights, leaving it to other law and regulation to fill in the details. The Part 5 rules cover such basic matters as the duty of the securities intermediary to pass through to entitlement holder the economic and corporate law rights of ownership of the security, including the right to receive payments, dividends, and distributions, and the right to exercise any voting rights. The Part 5 rules also specify that the securities intermediary has a duty to comply with authorized entitlement orders originated by the entitlement holder and to convert the entitlement holder's securities position into any other available form of securities holding that the customer requests, such as delivering a certificate or transferring the position to an account with another firm.

III. SECURITY INTERESTS IN INVESTMENT PROPERTY

A. General Approach of New Security Interest Rules

Prior to the 1978 amendments, the rules on security interests in investment securities were part of Article 9. Since the general rules of Article 9 provided that no separate security agreement was needed for a possessory security interest, and that possession was an effective method of perfection, the Article 9 rules could accommodate the traditional pledge of investment securities, in which the debtor delivers the certificates to the secured party, thereby both creating the security interest and perfecting it. Various special rules were included in the original version of Article 9 to accommodate certain limited situations where established practice recognized non-possessory security interests in securities, such as the provisions allowing a pledgee to return the securities to the debtor for a limited time to permit the debtor to present them for exchange in the event of a stock split, merger, or the like.

When the 1978 amendments provided for uncertificated securities, it became somewhat more difficult to fit all secured transactions involving securities into the general Article 9 provisions on pledges. Rather than attempt to alter the Article 9 provisions on attachment and perfection by possession in such fashion that they might cover uncertificated securities, which by definition could not be pledged, the decision was made to move the provisions on attachment and perfection from Article 9 to Article 8. Inasmuch as the Article 8 rules on transfer of ownership interest had already been altered to provide for both certificated and uncertificated securities, it seemed simpler to treat security interests in securities under Article 8, rather than to replicate the new Article 8 "possession equivalent" rules for uncertificated securities in Article 9. Doing so made it possible to treat security interests in uncertificated securities in the same fashion as security interests in traditional certificated securities.

The result was that the conceptual structure of the traditional possessory pledge remained the basis for security interests in securities, certificated or uncertificated, held directly or through securities intermediaries. Delivery could not, of course, be literally required for security interests in uncertificated securities, or for security interests in securities held by securities intermediaries, so the 1978 amendments substituted "transfer" for "delivery." The fundamental concept of the possessory pledge, however, was retained, so that a security interest could be created not simply by agreement, but by agreement coupled with a "transfer."

The notion that a security interest in securities can be created only by a possessory pledge or some equivalent or substitute has become rather anomalous with the evolution of modern securities holding practices. The vast bulk of all securities holdings are now in book entry form of some sort, where ownership interests are evidenced only by notation on the books of depositories such as DTC and securities intermediaries such as broker-dealers and custodian banks. Article 8 recognizes that ownership interests can be created in such systems merely by book entries. It is, then, somewhat odd to insist that a security interest, as distinguished from an ownership interest, can be created only by some special act akin to the delivery of a certificate in the traditional possessory pledge.

This revision abandons the notion that a security interest in a security can be created only by a method akin to the traditional possessory pledge. Under the revised Article 9 rules, a security interest in securities can be created pursuant to Section 9-203 in the same fashion as a security interest in any other form of property, that is, by agreement between the debtor and secured party. There is no requirement of a "transfer," "delivery," or any similar action, physical or metaphysical, for the creation of an effective security interest. A security interest in securities is, of course, a form of property interest, but the only requirements for creation of this form of property interest under this draft are those set out in Section 9-203.

Once the requirement of a "transfer" for the creation of a security interest is dropped, the rationale for putting the rules on security interests in securities in Article 8 rather than Article 9 largely disappears. There is no need for the provisions, found in various subsections of Section 8-313 of present law, for special rules stating that acts sufficient to create security interests are deemed to be equivalent to "transfers." Accordingly, this draft returns to the pre-1978 structure in which Article 9, rather than Article 8, sets out the rules on security interests in investment securities.

B. New Terminology

The first change in the Article 9 rules made in this draft is a change of terminology to conform the Article 9 rules to the new structure of Article 8. A person who holds a security directly has a direct property interest in the security. The interest of a person who holds securities through a securities intermediary is described as a "securities entitlement." The conforming amendments to Article 9 define a new category of Article 9 collateral, "investment property," which includes both securities and securities entitlements. See Revised Section 9-115(1)(d). Corresponding changes to other Article 9 definitions are made to exclude investment property from the categories of "instruments" and "general intangibles." Revised Sections 9-105(1)(i) and 9-106.

C. Attachment

Attachment of security interests in investment property is governed by Revised Section 9-203. Two mechanisms are possible: (1) execution of an ordinary Article 9 security agreement containing a description of the collateral, and (2) having the secured party obtain "control" over the investment property. The concept of "control" is used in various provisions of Revised Article 8 and the corresponding Article 9 amendments. For purposes of the attachment rule, the main significance is that taking possession of a certificated security counts as "control." Thus, as in present law, no written security agreement is required for attachment when the secured party has possession of certificated securities.

D. Perfection

Perfection of security interests in investment property is governed by Revised Section 9-304(7) and (8). Revised Section 9-304(8) deals secured financing of securities firms; Revised Section 9-304(7) is the general rule for security interests granted by persons other than securities firms.

Revised Section 9-304(7) provides that if the debtor is not a securities intermediary, a security interest in its investment property can be perfected by filing, just as is the case for other forms of property such as tangible goods or accounts. It should be noted, however, that Revised Section 9-304(7) is only a perfection rule. A secured party who relies on filing will not necessarily assure itself of priority over other secured parties. As an alternative to filing, Revised Section 9-304(7) provides that a security interest can be perfected by the secured party obtaining "control." "Control" is defined in Revised Section 9-116. In rough form, the term means that the secured party has taken whatever steps may be necessary, given the manner in which the debtor holds the securities, to place itself in a position where it can, without the need for further acts by the debtor, have the securities sold. Because "control" includes taking possession of certificated securities, this perfection rule continues present law under which security interests in certificated securities can be perfected by possession. Other provisions of the Revised Section 9-116 definition of "control" cover other methods that are currently used to create and perfect security interests under the guise of "possession." Thus, this perfection rule makes it possible to implement such arrangements without concern over the uncertainties that result from forcing such arrangements into the concepts of "possession" drawn from common law pledge cases. Finally, subsection (1)(d) of Revised Section 9-116 provides that when a security interest in a securities entitlement is granted by the entitlement holder to the securities intermediary itself, the intermediary is deemed to have control. The common scenario covered by this rule would be a margin loan from a broker to its customer. As is the case with many applications of the "control" concept, the effect of this rule is not to change the law, but to place on a sounder basis practices that currently rest on manipulation of the concept of possession.

Revised Section 9-304(8) deals with cases where a broker, securities intermediary, or commodity intermediary is the debtor, and grants a security interest in its investment property to a lender or other secured party. At present, the Draft sets out alternative versions; the Drafting Committee does not however intend to leave this matter to non-uniform choice by individual states, but plans to resolve the issue one way or the other in light of comments and suggestions from the securities industry, its lenders, and other interested parties. Version 1 provides that a such a security interest is automatically perfected. This is not, as it may at first seem, a novel departure from existing rules. Rather, it is essentially a more clear statement of the actual current rules. Present law provides that a security interest in securities given for new value under a written security agreement is perfected without filing or possession for a period of 21 days. Securities firms can use this provision to obtain secured financing for their inventory under so-called "agreement to pledge" arrangements. Though in legal theory the security interests are temporary, the financing arrangement can in practice be continued indefinitely by rolling over the loans at least every 21 days. The result is that any knowledgeable creditor of a brokerage will realize that the firm's securities may be subject to security interest that are not discoverable from any public records. Version 2 provides that a security interest granted by a broker, securities intermediary, or commodity intermediary is perfected if the firm has made entries on its books reflecting that the secured party has a security interest in the investment property in question. As explained in the Comment to Revised Section 9-304(8) this version is based upon non-uniform amendments to present law that were adopted in New York to provide a clearer legal basis for agreement to pledge financing than the 21-day automatic perfection rule.

E. Priorities

Revised Section 9-312(8) deals with priorities between conflicting security interests in investment property. It establishes several special priority rules for conflicting security interest in investment property. In cases not covered by one of these special rules, priority is determined by the general first in time of filing or perfection rule of Section 9-312(5). The principal priority rule is that a secured party who has obtained "control" has priority over a secured party who has not done so. For example, a secured party who perfects a security interest in a certificated security by filing would lose to a later secured party who obtained possession. Similarly a secured party who perfects a security interest in a debtor's securities entitlements by filing would lose to a later in time secured party who obtained a tri-party agreement under which the intermediary agreed to act on the secured party's instructions.

F. Application of Revised Article 9 Rules

1. New Arrangements for Security Interests in Certificated Securities Made Possible by the Revision.

Under present law, the possessory pledge is the only realistic option available to a person who holds securities in the ordinary certificated, direct form and wishes to use them as collateral for a loan. In many situations the debtor might prefer to retain possession, but that is not feasible today even if the lender would otherwise be willing to accept the consequent risks of debtor misbehavior. For the secured party to have a perfected security interest, it must take possession. In effect, the lender who trusts the debtor's honesty, but has reservations about the debtor's credit standing, is prevented by the legal rules from adopting an arrangement that fits the parties assessments of the risks. The only way to protect against credit risk is to take the step necessary to protect against honesty risk -- take the collateral out of the debtor's hands. For other forms of personal property, the Article 9 rules permit the lender and debtor to implement more precisely tailored arrangements. Perfection can be achieved by filing. Protection against debtor misbehavior can, if desired, be achieved by taking possession or other policing techniques. This revision makes these same choices available to debtors and lenders with respect to securities. A lender who is otherwise willing to leave the collateral in the debtor's hands can perfect by filing a financing statement. If that risk is thought unacceptable, the lender can take possession.

The option of perfection by filing may also be useful in circumstances where the lender wishes to take possession of the securities, but is willing to return them to the debtor for some limited or temporary purpose, such as exchange, registration of transfer, or the like. Under present law, Section 9-304(5) permits a secured lender to return securities to the debtor, without losing perfected status, but only for a period of 21 days. Under the revision a lender in that situation could file a financing statement to assure itself of perfection in the event that it took more than 21 days to carry out the transaction involved.

2. Security Interests in Securities Held by Investors Through Financial Intermediaries.

One of the objectives of the revision is to facilitate, to as great an extent as is practicable, transactions in which investors wish to use their securities positions held though securities intermediaries as collateral for loans. The revision eliminates all of the obstacles to such arrangements that result from the uncertainties of present law. Under Revised Article 8, a person who holds securities through an account with a broker or custodian has a securities entitlement. The proper perfection methods for securities entitlements are stated specifically in Revised Section 9-304. If the debtor is not a securities intermediary, the secured interest can be perfected by filing a financing statement or by "control." Two methods of obtaining control are possible. First, the secured party could be designated as the entitlement holder, or, to put it colloquially, the securities in the account could be transferred outright to the secured lender on the books of the debtor's securities intermediary or some other intermediary with whom the secured party has an account. Revised Section 9-116(1)(c)(i). Second, if the securities intermediary is willing to enter into an explicit agreement in which it agrees to act on the directions of the secured party, the secured party obtains control under Revised Section 9-116(1)(c)(ii) even though the debtor remains listed as the entitlement holder and retains the right to trade the securities in the account.

The revision also clarifies the law concerning secured financing of securities firms. The rules of the revision facilitate this financing by treating the security arrangements in a fashion consistent with the general Article 9 concepts that have proved workable for inventory financing in other industries. The pledge model of present law requires these transaction to be structured as if they were individual, one-shot transactions involving specific items of property. Under the revision, the legal framework can be the same as for other forms of inventory financing. An ordinary written security agreement suffices for attachment; the collateral can be described, in whatever fashion or detail suits the arrangement. In the securities industry, unlike other businesses, it is common for firm to establish arrangements with several lenders, and to grant to specific lenders security interests in specific collateral. Under this revision, these arrangement can easily be implemented as a matter of the description of the collateral in the agreement or supplementary listings. The secured party who relies on such an arrangement does, of course, take the risk that the debtor will double finance, and do so in a fashion that gives the other lender priority. If the lender finds that risk excessive, it can require the debtor to take the steps necessary to give the lender control, and thereby obtain the benefit of the priority rule of Revised Section 9-312(8).

For individual investors, the rules of this revision eliminate legal uncertainties that operate as obstacles to the use of securities held through securities intermediaries as collateral for third party loans. There is, however, probably nothing that legal rules can do to place all possible lenders on a completely even playing field. The broker through whom a person holds securities has the inherent advantages as a lender. It knows at all times exactly what the investors securities position is and can protect against risk of debtor misbehavior at essentially no additional cost. There is, however, a question of policy in the choice of priority rules to govern situations where an investor borrows from and grants a security interest to both to a third party and to the broker. In order to facilitate the ability of investors to use their securities accounts entitlements as collateral for loans from other lenders, one could try to design a priority rule that made it possible for an independent lender to obtain a first priority security interest that would not be subordinated to any security interests that the investor might latter grant to the securities intermediary. Adopting such a rule, however, might impair the ability of investors to obtain margin financing, or even conduct ordinary dealing with their brokers, such as paying by check for securities that they have purchased, because brokers would have to investigate to assure themselves that no prior liens had been created in the investors securities entitlements. Revised Section 9-312(8) takes the approach of conferring certainty on the broker's position. It provides that a security interest granted by an entitlement holder to the securities intermediary has priority over any security interests granted to other parties, except where the broker has allowed the debtor to transfer the securities outright to another secured party.

G. Special Provisions on Registered Pledge Unnecessary

One consequence of adopting the security interest structure of this revision, is that it becomes unnecessary to have special statutory provisions for registered pledges of uncertificated securities. The reason that the 1978 version of Article 8 created this concept was that if the only means of creating security interests was the pledge, it seemed necessary to provide some substitute for the pledge when one eliminated the certificate. The point of the registered pledge is, presumably, that it permits a debtor to grant a perfected security interest in securities, yet still keep the securities in the debtor's own name for purposes of dividends, voting, and the like. The concept of registered pledge has, however, been thought troublesome by many legal commentators and securities industry participants. For example, in Massachusetts, where many mutual funds have their headquarters, a non-uniform amendment was enacted when the 1978 amendments were adopted, to permit the issuer of an uncertificated security to refuse to register a pledge, instead issuing a certificate to the owner that the owner could then pledge by ordinary means.

Under present Article 8, if an issuer chooses to issue securities in uncertificated form, it must also offer a registered pledge program. Revised Articles 8 and 9 take a different approach. All of the provisions dealing with registered pledges have been deleted. This does not mean, however, that issuers cannot offer such a service. The rules of Revised Section 9-116 concerning "control," and the related priority provisions, establish a structure that permits issuers to develop systems akin to the registered pledge device, without mandating that they do so, or legislating the details of the system. Experience in the indirect holding system suggests that the approach of leaving this matter to private arrangements is feasible. DTC, for example, offers its participants a service akin to the registered pledge device. By agreement among

DTC, the debtor, and the secured party, DTC will set up a pledge account into which the debtor can have securities transferred as collateral for loans from the secured party. DTC will hold the securities in the pledge account subject to the instructions of the secured party. In essence, the DTC pledge program really amounts to a record keeping service. If the parties wish to pay DTC for the service, DTC will keep track of which securities the secured party holds for its own account outright, and which securities it holds in pledge from its debtors. If the parties do not want that record keeping service, they can have the securities transferred to the secured party outright, and the secured party can keep it own records about the capacity in which it holds the securities in its DTC account.

Under the rules of this revision, the registered pledge question can easily be left to resolution by the market. The concept of control is defined in such fashion that if an issuer or securities intermediary wishes to offer a service akin to the DTC pledge program it can do so. The issuer or securities intermediary would offer to enter into agreements with the debtor and secured party pursuant to which it will hold the securities for the account of the debtor. but subject to instructions from the secured party. The secured party would thereby obtain control assuring perfection and priority of its lien.

Even if such arrangements are not offered by issuers, persons who hold uncertificated securities will have several options for using them as collateral for secured loans. If the debtor is a broker the secured party can rely on the [automatic perfection / book-marking] rule of Revised Section 9-304(8). If the debtor is not a broker, the secured party can perfect by filing a financing statement under Revised Section 9-304(7). Either of these methods does, of course, leave the secured party exposed to the risk that the debtor will double finance and grant a latter secured lender a security interest under circumstances that give that lender control and hence priority. If the lender is unwilling to run that risk, the debtor can transfer the securities outright to the lender on the books of the issuer, though between the parties the debtor would be the owner and the lender only a secured party. That, of course, requires that the debtor trust the secured party not to dispose of the collateral wrongfully, and the debtor may also need to make arrangements with the secured party to exercise benefits of ownership such as voting and receiving distributions.

It may well be that both lenders and borrowers would prefer to have some arrangement, such as the registered pledge device of current law, that permits the debtor to remain as the registered owner entitled to vote and receive dividends but give the lender the power to prevent the debtor from disposing of the securities and to itself order their disposition. The approach taken in this revision is that if there is a genuine demand for such arrangements. it can be met by the market. Debtors and lenders would presumably have to pay for the service, since it imposes record keeping and other administrative costs on the issuers, but there is no obvious reason why they should not pay for such services. The difficulty with the approach of present Article 8 is that it mandates that any corporation that wishes to issue securities in uncertificated form must also offer this record keeping service. That obligation may well act as a disincentive to the development of uncertificated securities. Thus, the deletion of the mandated registered pledge provisions is consistent with the principle of neutrality toward the evolution of securities holding practices.

IV. NOTE ON THE TERMINOLOGY AND CONCEPTS OF REVISED ARTICLE 8

A. Ambiguity of "Security"

Although Revised Article 8 adopts new terminology and a new conceptual structure for describing the interests of person who holds securities through securities intermediaries, the new commercial law rules will not require wholesale changes in terminology or approach to transactions involving securities. To see why, it may be useful to analyze a simple scenario:

Suppose that Sally and Betty are each interested in investing in the common stock of XYZ Co. They each go to their respective brokers and place an order to purchase 1000 shares of XYZ Co common stock. Sally tells her broker that she wishes to receive a certificate evidencing her investment. Betty tells her broker that she wishes to hold her investment in an account with the broker. Both transactions are executed. Sally receives a certificate showing that she is the registered owner of 1000 shares, and Betty receives a statement from her broker showing that 1000 shares have been credited to her account. For most purposes, the difference in the ways that Sally and Betty have chosen to hold their investment in XYZ Co common stock is irrelevant. For example, if called upon to produce financial statements in connection with obtaining loans, each could truthfully report that she is the owner of 1000 shares of XYZ common stock. The difference between their situations is not that they have chosen to invest in different assets, but that they have chosen different ways of investing in the same asset.

If it were possible to start from scratch in terminology, there would be much to be said for using one set of terms to refer to the underlying asset and a different set of terms to refer to the way in which that asset is held. We might, for example, say that although the underlying asset that Sally and Betty own is "1000 shares of XYZ common stock," Sally's evidence of her share ownership is a "securities certificate," while Betty's evidence of her share ownership is a "securities entitlement." However desirable a terminological convention such as this might be, the drafters of statutes -- and even more so the revisers of statutes -- must accept usage as they find it. Unfortunately for these purposes, existing usage of the term "security" blurs the distinction between the underlying asset and the evidence of ownership. With respect to shares represented by certificates, the term "security" has long been used to refer both to the intangible interest and the certificate, and Article 8 explicitly sanctions this ambiguity. In the era when all "securities" -- in the sense of the underlying assets governed by Article 8 -- were represented by certificates, this ambiguity was not a significant problem. As other means of evidencing ownership have developed, such as uncertificated direct holdings and holdings through intermediaries, the ambiguity becomes more troublesome. It would, however, probably be futile for Article 8 to attempt to force lawyers and business people to change usage in order to facilitate discussion of the issues governed by Article 8. Accordingly, Revised Article 8 accepts as inevitable that the term "security" is used in different senses. It may, however, be useful to note explicitly the ways in which terms are being used in a senses that are potentially confusing.

Beginning with the forms of investment interests that are the core concern of Article 8, such as corporate stocks and bonds, we have the following possibilities:

Underlying Asset	**Evidence of Ownership**
Share of common stock ("Security")	Stock certificate ("Security")
	Registration on the books of the issuer as owner of uncertificated share ("Security")
	Entries on the books of an intermediary ("Securities Entitlement")

In common usage, the underlying asset -- the share of common stock -- is referred to as a "security," and Article 8 accepts that usage. A person who owns such a "security" might chose to hold that "security" in three different ways: (1) take possession of a certificate; (2) become the registered owner of shares in uncertificated form (if the issuer offers uncertificated shares); or (3) hold the shares through an account with an intermediary. Revised Article 8 follows present usage and law in using the term "security" to refer to the first two of these three forms in which an investor might hold the underlying asset. That is, a person whose interest in the underlying asset is evidenced by possession of a certificate or by registration on the books of the issuer is described as the "holder" of a "security." Thus, in these cases the term "security" is being used to refer both to the underlying asset and to the form of evidence of ownership. Revised Article 8 changes terminology only with respect to the third form of evidence of ownership. Under Present Article 8, a person whose ownership of shares of common stock is evidenced by entries on the books of an intermediary is described as a "purchaser" of an interest in "a security," just as a person whose ownership of shares of common stock is evidenced by physical possession of a certificate is described as a "purchaser" of an interest in "a security." Under Revised Article 8, by contrast, a person whose ownership of shares of common stock is evidenced by entries on the books of an intermediary is described as having a "securities entitlement."

Thus, if one asks whether a person who has a securities entitlement is the "owner of a security" the answer is yes or no depending on the context. If the focus of the discussion is the underlying asset, it is perfectly natural to say that a person who has a securities entitlement is the "owner of a security." If the focus of the discussion is the evidence of ownership, it is inappropriate to describe the person as the "holder" of a "security"; instead one should describe the person as having a securities entitlement.

To illustrate the varying contexts in which the term "security" might be used, consider a simple transaction. Suppose that Sally enters into a contract to sell 1000 shares of XYZ Co common stock to Betty. Sally's performance obligation under the sales contract is to take the appropriate steps to place Betty in the position where Betty has the package of rights and interests against XYZ Co that constitute ownership of common stock. Sally might perform her obligation in various ways, such as the following:

Case 1. Suppose that both Sally and Betty prefer to hold their securities in certificated form. Sally has a certificate evidencing that she is the registered owner of 1000 shares of XYZ Co. stock. She could perform her obligation under the sales contract by delivering the certificate to Betty with proper indorsement or stock power. Betty could then have the transfer registered by the issuer and obtain a certificate evidencing that she is the registered owner of 1000 shares of XYZ Co. stock.

Case 2. Suppose that Sally holds her securities through an account at her broker, Able & Co., but Betty prefers to hold her securities in certificated form. Sally has no certificate that could be delivered to Betty, so she must satisfy her performance obligation under the sales contract in some other way, as, for example, by directing her broker Able & Co. to debit her account for the 1000 shares and cause the necessary book entries to be made, ordinarily through a clearing corporation, so that XYZ Co.'s transfer agent will issue a certificate to Betty evidencing that Betty is the registered owner of 1000 shares of XYZ Co. stock.

> **Case 3.** Suppose Sally holds her securities through an account at her broker, Able & Co., and Betty holds her securities through an account at her broker, Baker & Co. Sally can satisfy her performance obligation under the sales contract by directing her broker to debit her account for 1000 shares of XYZ Co. stock and cause the necessary book entries to be made so that Betty's broker will credit Betty's account for 1000 shares of XYZ Co. stock.

The subject matter of the sales contract is the underlying asset -- the 1000 shares of XYZ Co. common stock. Accordingly, it would be perfectly natural to describe any of these transactions as contracts for the sale of "a security," using that term to refer to the underlying asset.

The difference among these three cases is a matter of how the parties chose to evidence their ownership of the underlying asset. The difference in the means of evidencing ownership does mean that a different terminology is required in analyzing how the contract for sale was settled. Analysis of settlement requires that we focus on how each party chose to evidence her ownership and how the circumstances were changed so that Betty, rather than Sally, would have evidence of ownership. Under Revised Article 8, the steps would be described as follows:

> **Case 1.** Sally was the holder of a certificated security. She transferred that security to Betty by giving Betty physical possession of the certificate, along with a proper indorsement. Thereupon Betty became the holder. Upon registration of the transfer by the issuer, Betty became the registered owner.

> **Case 2.** Sally was not the holder of a security; rather she had a securities entitlement to 1000 shares of XYZ Co. common stock. She initiated an entitlement order to her securities intermediary, Able & Co., directing that Able & Co. dispose of her securities entitlement by debiting her account for 1000 shares and causing the appropriate entries to be made so that XYZ Co.'s transfer agent would issue a certificate to Betty. In the usual case, Able & Co. would have carried out this entitlement order by in turn initiating an entitlement order to Able & Co.'s securities intermediary, DTC, directing DTC to dispose of Able & Co.'s securities entitlement to 1000 shares by debiting Able & Co.'s account for 1000 shares and causing the appropriate entries to be made so that XYZ Co.'s transfer agent would issue a certificate to Betty. DTC was the registered owner of a security, so DTC can instruct XYZ Co.'s transfer agent to transfer 1000 shares to

> Betty. When the transfer agent does so, Betty becomes the holder of a security.
>
> **Case 3.** Sally was not the holder of a security; rather she had a securities entitlement to 1000 shares of XYZ Co. common stock. She initiated an entitlement order to her securities intermediary, Able & Co., directing that Able & Co. dispose of her securities entitlement by debiting her account for 1000 shares and causing the appropriate entries to be made so that Baker & Co. would credit Betty's account for 1000 shares. In the usual case, Able & Co. would have carried out this entitlement order by in turn initiating an entitlement order to Able & Co.'s securities intermediary, DTC, directing DTC to dispose of Able & Co.'s securities entitlement to 1000 shares by debiting Able & Co.'s account for 1000 shares and crediting Baker & Co.'s account. When DTC does so, Baker & Co. acquires a securities entitlement against DTC to 1000 shares of XYZ. When Baker & Co. credits Betty's account, Betty acquires a securities entitlement against Baker & Co. to 1000 shares of XYZ.

In this analyses, the terms "security" and "securities entitlement" refer to the evidence of ownership, rather than to the underlying assets. Accordingly it is necessary to distinguish between being the "holder of a security" and "having a securities entitlement."

It is, however, worth bearing in mind that in many, if not most, legal contexts, the difference in the Article 8 analysis of various mechanisms of settlement of a sales contract is essentially irrelevant. Suppose, for example, that Betty bought the XYZ Co. stock at a time when the price was rising in response to misleadingly positive earnings reports issued by XYZ Co. Betty brings an action against officers of XYZ Co. alleging violations of the Federal securities laws. Betty would obviously have satisfied the "purchaser" requirement for bringing an action under Rule 10b-5; the differences among Cases 1, 2, and 3 concerning how the transaction between Sally and Betty had been settled are irrelevant. In this context, what "purchaser" means is a person who has given value to acquire the package of corporate law rights that comprise ownership of XYZ Cop. common stock. To take another example, suppose that Sally contends that Betty committed some form of fraud that induced Sally to enter into the sales contract and therefore Sally has the right to rescind or recover damages. Here too, it makes no difference how Sally performed the obligation she incurred in the sales contract; what matters is that Betty induced Sally by fraud to part with her 1000 share position in XYZ Co. stock. Since there are no legal issues about the way in which the parties held their shares, or how the contract for the sale was settled, there is no need to go through the precise Article 8 analysis. Accordingly it would be pedantic to insist that locutions such as "Sally transferred 1000 shares to Betty," or "Betty bought 1000 shares of XYZ from Sally," could appropriately be used only if the transaction had been settled as in Case 1 and that in the other cases one must speak of Sally having initiated an entitlement order with respect to her securities entitlement, or Betty having acquired a securities entitlement in reliance upon misleading financial information.

In other legal contexts it is important to distinguish among various means of evidence of ownership, and thus it is becomes essential to go through the analysis of the transaction under the new terminology of Revised Article 8. Suppose for example that Debbie owns 1000 shares of XYZ Co. stock and wishes to borrow money from Carol using her XYZ Co. stock as collateral for the loan. The secured transaction might be implemented in a variety of ways:

> **Case 4.** Suppose that Debbie had a certificate evidencing that she was the registered owner of 1000 shares of XYZ Co. stock. She could deliver the certificate to Carol with proper indorsement or stock power.

> **Case 5.** Suppose that Debbie holds her securities through an account at her broker, Able & Co., and that Carol also has a securities account at Able & Co. Debbie could instruct Able & Co. to transfer 1000 shares of XYZ Co. stock from her account to Carol's account.

> **Case 6.** Suppose that Debbie holds her securities through an account at her broker, Able & Co., and that Carol has a securities account at Baker & Co. Debbie could instruct Able & Co. to transfer 1000 shares of XYZ Co. stock from her account to Carol's account at Baker & Co.

Each of these three cases could be described as ones in which Debbie granted a security interest to Carol in her position in XYZ Co. common stock, so that Carol then had an interest as secured party in 1000 shares XYZ Co. common stock position. Indeed, if one uses the term "security" to refer to the underlying asset rather than to the evidence of ownership, one could describe each of these cases as ones in which Debbie granted Sally a security interest in a "security." That usage, however, is likely to generate confusion, because the precise means in which the transaction was implemented is often significant in analyzing secured transactions. In particular, if one asks whether Carol's security interest is "perfected," one is asking a question about whether the appropriate steps have been taken to implement the creation in Carol of an interest in the 1000 shares XYZ Co. common stock position. That is precisely the sort of question where it matters how the parties chose to hold the underlying asset. The analysis under Revised Articles 8 and 9 would be as follows:

> **Case 4.** Debbie's ownership interest in 1000 shares of XYZ Co. stock was evidenced by a certificate showing her as registered owner. Under Article

8 she is treated as the holder of a security. She granted a security interest to Carol in her 1000 share position in XYZ Co. stock. The secured transaction was implemented by delivery of the certificate. Carol's security interest is perfected because Carol obtained physical possession of the certificate. See §§ 9-116(1) and 9-304(7). While Carol has possession, she is the holder and Debbie is not the holder. As between Debbie and Carol, however, Debbie is the owner and Carol is a secured party; that is Carol is the holder of the security, but she holds it as secured party rather than outright owner. Thus, if Debbie repays the debt, Carol is obligated to return the collateral to Debbie.

Case 5. Debbie's ownership interest in 1000 shares of XYZ Co. stock was evidenced entries on the books of Able & Co. Under Article 8 she is not treated as the holder of a security, but as having a securities entitlement against Able & Co. to 1000 shares of XYZ Co. stock. She granted a security interest to Carol in her 1000 share position in XYZ Co. stock. The secured transaction was implemented by having Able & Co. debit Debbie's account and credit Carol's account. Carol's security interest is perfected because Carol became the entitlement holder having a securities entitlement against Able & Co. to 1000 shares of XYZ Co. stock. See §§ 9-116(1)(c)(i) and 9-304(7). Carol, not Debbie, is now the entitlement holder. As between Debbie and Carol, however, Debbie is the owner and Carol is a secured party; that is Carol is the entitlement holder, but she has the securities entitlement as secured party rather than outright owner. Thus, if Debbie repays the debt, Carol is obligated to return the collateral to Debbie.

Case 6. Debbie's ownership interest in 1000 shares of XYZ Co. stock was evidenced entries on the books of Able & Co. Under Article 8 she is not treated as the holder of a security, but as having a securities entitlement against Able & Co. to 1000 shares of XYZ Co. stock. She granted a security interest to Carol in her 1000 share position in XYZ Co. stock. The secured transaction was implemented by debiting Debbie's account at Able & Co., crediting Carol's account at Baker & Co., and making appropriate adjustments in Able and Baker's accounts at DTC. Carol's security interest is perfected because Carol became the entitlement holder having a securities entitlement against Baker & Co. to 1000 shares of XYZ Co. stock. See §§ 9-116(1)(c)(i) and 9-304(7). Carol, not Debbie, is now the entitlement holder. As between Debbie and Carol, however, it remains the case that Debbie is the owner of the 1000 XYZ position, and Carol's interest is that of a secured party; that is Carol is the entitlement holder, but she has the securities entitlement as secured party rather than outright owner. Thus, if Debbie repays the debt, Carol, is obligated to return the collateral to Debbie.[1]

Although precision in the usage of the new terminology will often be important in discussion of security interests in investment property, this will not always be the case. Suppose, for example, a dispute arises about whether Debbie is in default, or whether Carol has acted in a proper fashion in disposing of the collateral after default. The method of perfection would not matter, so there would be no need to distinguish among Cases 4, 5, and 6. Rather, it would be entirely natural to describe these simply as cases in which Debbie granted Carol a security interest in 1000 shares of XYZ common stock.

B. Application of Indirect Holding System Rules to Financial assets other than "Securities"

As is explained in the Comment to Section 8-104, the new indirect holding system rules of Part 5 of Revised Article 8 apply to a broader class of property than "securities" in the narrowest sense. For example, the depository system that has evolved for stocks and bonds also provides an efficient means of recording and transferring interests in money market instruments, such as commercial paper, bankers acceptances, and certificates of deposit. Revised Section 8-102(a)(11) defines a new term "financial asset" to refer to a broad class of property that might be held through intermediaries. Although the rules of Parts 2, 3, and 4 of Article 8 would not apply to financial assets that do not also fall within the narrower definition of "security" in Section 8-102(a)(18), the indirect holding system rules of Part 5 would apply to this broader class, insofar as they are held through intermediaries.

The expansion of the indirect holding system rules beyond the narrow category of traditional investment securities adds another dimension to the terminological problem. As was noted above, there are various forms of evidence of ownership of the underlying assets that fall within the narrow definition of "security." One of these means of evidencing ownership -- the "securities entitlement" -- can be used even for underlying assets that do not fall within the narrow definition of "security." An expanded version of the table presented above may aid understanding:

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[1] It should be noted that Cases 4, 5, and 6, do not represent a complete listing of the means of perfection. They are discussed here only for purposes of illustrating general points about the new terminology of Revised Articles 8 and 9. The specifics of the rules on perfection are explained in the Comment to Sections 9-116 and 9-304.

Underlying Asset	**Evidence of Ownership**
Share of common stock ("Security")	Stock certificate ("Security")
	Registration on the books of the issuer as owner of uncertificated share ("Security")
	Entries on the books of an intermediary ("Securities Entitlement")
Money market instrument, e.g. bankers acceptance ("Article 3 Negotiable Instrument"; "Financial asset")	Possession of writing embodying obligation ("Article 3 Negotiable Instrument")
	Entries on the books of an intermediary ("Securities Entitlement")

A money market instrument, such as a bankers acceptance, remains an Article 3 negotiable instrument; it would not be treated as a "security" under Section 8-102(a)(18). Thus, Article 3, rather than Article 8, would provide the governing law on the obligations of the immediate parties, such as the obligations of an acceptor, the mechanics of presentment, and the rights of a person having possession of the written instrument. One the other hand, if a money market instrument is held by a clearing corporation, the rights of the clearing corporation's participants with respect to that money ,market instrument would be governed by Part 5 of Article 8. In contexts where the means of evidence of ownership is significant, the interests of the participants would be described as "securities entitlements" to the money market instrument.

The complexity in the terminology of Revised Article 8 is regrettable, yet no simple solution is apparent. The heart of the difficulty is the ambiguity that is well-entrenched in current business and legal usage -- the term "security" is used both to refer to the underlying asset and the certificates that are the traditional means of evidencing ownership. Unless the term "security" is to be abandoned altogether, or given a restrictive definition at odds with common usage, one must live with that ambiguity. The key to the new Article 8 terminology may be to remember a basic point. No one would care about possession of stock certificates but for the fact that legal rules and commercial practice make possession of certificates significant for purposes of determining rights to shares of common stock. Neither "securities certificates" nor "securities entitlements" are ends in themselves; they are means to an end -- enjoyment of the package of economic and corporate rights that comprise ownership of common stock or other investments.

V. TABLE OF DISPOSITIONS OF SECTIONS IN FORMER ARTICLE 8

Article 8 (1978)	**Revised Article 8 and 9**
8-101	8-101
8-102(1)(a) & (b)	8-102(a)(18)
8-102(1)(c)	8-105
8-102(1)(d)	8-102(a)(14)
8-102(1)(e)	8-102(a)(2)
8-102(2)	8-202(b)(3)
8-102(3)	8-102(a)(5)
8-102(4)	omitted
8-102(5)	8-102(b) & (c)
8-102(6)	8-102(d)
8-103	8-209
8-104	8-210
8-105(1)	8-116
8-105(2)	omitted
8-105(3)	8-117
8-106	8-112
8-107	omitted
8-108	omitted
8-201	8-201
8-202	8-202
8-203	8-203
8-204	8-204
8-205	8-205
8-206	8-206
8-207	8-207
8-208	8-208
8-301	8-301
8-302	8-302
8-303	8-102(a)(3)
8-304(1)	8-108(c) & 8-304(b)
8-304(2)	omitted
8-304(3)	8-108(a)
8-305	8-108(b)
8-306(1)	8-109(c) & (e)

8-306(2)	8-109(a)
8-306(3)	8-109(g)
8-306(4)	8-109(h)
8-306(5)	8-109(d)
8-306(6)	8-308(c)
8-306(7)	8-109(b) & 8-307(d) & 8-308(c)
8-306(8)	omitted
8-306(9)	omitted
8-306(10)	8-109(i)
8-307	8-305(e)
8-308(1)	8-102(a)(12)
8-308(2)	8-305(b)
8-308(3)	8-305(c)
8-308(4)	8-102(a)(13)
8-308(5)	8-102(a)(13)
8-308(6)	8-106(a)(1)
8-308(7)	8-106(a)(2)
8-308(8)	8-106(b)
8-308(9)	8-305(a) & 8-306
8-308(10)	8-106(c)
8-308(11)	8-106(d)
8-309	8-305(d)
8-310	8-305(f)
8-311(a)	8-407
8-311(b)	omitted
8-312(1)	8-307(a)
8-312(2)	8-307(b)
8-312(3)	8-308(b)
8-312(4)	8-307(c)
8-312(5)	8-308(a)
8-312(6)	8-308(c)
8-312(7)	omitted
8-312(8)	8-307(d) & 8-308(c)
8-313(1)(a)	8-303(a)
8-313(1)(b)	8-303(b)
8-313(1)(c)	8-303(c)
8-313(1)(d)	omitted, see 8-501
8-313(1)(e)	8-303(d)
8-313(1)(f)	8-303(e)
8-313(1)(g)	omitted, see 8-501
8-313(1)(h)-(j)	omitted, see 9-116, 9-203, 9-304(7) & (8)
8-313(2)	omitted, see 8-102(b) & (c), 8-503

8-313(3)	omitted
8-313(4)	8-102(a)(17)
8-314	omitted
8-315	omitted
8-316	8-309
8-317	8-111
8-318	8-310
8-319	omitted, see 8-114
8-320	omitted, see 8-501
8-321	omitted, see 9-116, 9-203, 9-304(7) & (8)
8-401(1)(a)-(b)	8-401(a)(2)-(3)
8-401(1)(c)	omitted
8-401(1)(d)-(e)	8-401(a)(4)-(5)
8-401(2)	8-401(b)
8-402(1)	8-402(a)
8-402(2)	8-402(b)
8-402(3)	8-402(c)
8-402(4)	omitted
8-403	omitted, see 8-403(a)(2) & 8-403(c)
8-404(1)	8-403(c)
8-404(2)	8-403(b)
8-404(3)	8-403(b)
8-405(1)	8-405(a)
8-405(2)	8-404(a)
8-405(3)	8-404(b)
8-406(1)(a)	omitted
8-406(1)(b)	8-406
8-406(2)	omitted
8-407	omitted
8-408	omitted, see 8-405(b)