

Senate Fiscal Agency  
P. O. Box 30036  
Lansing, Michigan 48909-7536

**SFA****BILL ANALYSIS**

Telephone: (517) 373-5383  
Fax: (517) 373-1986  
TDD: (517) 373-0543

Senate Bill 299 (Substitute S-1 as passed by the Senate)  
Sponsor: Senator Christopher D. Dingell  
Committee: Financial Services

Date Completed: 10-24-97

### **RATIONALE**

Article 8 of the Uniform Commercial Code (UCC) governs transactions involving investment securities, such as stocks and bonds. Traditionally, these transactions involved the actual physical delivery and possession of certificates representing the securities, which evidently led to a "paperwork crunch" in the late 1960s. As a result, brokers, dealers, banks, and others in the securities market developed the "indirect holding system". While this system retains the use of certificated securities, the certificates typically are issued to depository institutions, which maintain securities accounts with brokerages. The brokerages in turn maintain securities accounts for the individual owners of the securities.

In practice, the trading of securities of public corporations is done through participating members of the Depository Trust Company (DTC) in New York, which acts as the primary depository of securities in this country. Rather than exchanging physical certificates at the end of each trading day, the system makes transfers through balancing, or netting, the participants' DTC accounts. The DTC system is considered an indirect holding system because the issuer's records do not show the identity of all of the beneficial owners of the securities.

Michigan adopted its current version of Article 8 in 1987--after the paperwork crunch had arisen in the '60s but before the securities market had established the indirect holding system. This version of Article 8 anticipated a securities trading system based on "uncertificated securities"--which never fully developed--and was designed for a system that still used the delivery of physical certificates or one in which the issuer kept records of the owner. Neither of these methods, however, remains common practice under the indirect holding system.

Recently, the National Conference of Commissioners on Uniform State Laws proposed a new system of rules to reflect practices in the modern securities market, and drafted Revised Article 8. Reportedly, 36 states have adopted the new article. In addition, new regulations of the Treasury/Reserve Automated Debt Entry System (TRADES), a commercial book-entry system operated by the Federal Reserve banks, evidently have established Revised Article 8 as the rule for some securities. It has been suggested that Michigan, also, should rewrite Article 8 to reflect current practices.

### **CONTENT**

**The bill would amend Article 8 of the Uniform Commercial Code to govern the rights and duties between "securities intermediaries" and "entitlement holders"; eliminate the requirement that, to enforce a contract for the sale of securities, there be some form of writing or an admission in court that a contract exists; and specify the jurisdiction in which disputes would have to be resolved. The bill also would amend Articles 1, 4, 5, and 9 of the UCC to bring those articles into conformity with the proposed changes to Article 8. The bill would take effect on January 1, 1998.**

#### Writing Requirement

The bill would repeal a number of sections of Article 8, including a section under which a contract for the sale of securities is not enforceable unless there is some form of writing or an admission in a court proceeding that a contract exists (MCL 440.8319). The bill specifies that a contract or modification of a contract for the sale or purchase of a security would be enforceable whether or not there was a writing signed or record authenticated by a party against whom enforcement was sought,

even if the contract or modification were not capable of performance within one year of its making.

#### Rights & Duties of Securities Intermediary & Entitlement Holder

Part 5 of the proposed Article 8 governs the rights and duties between securities intermediaries and entitlement holders. "Entitlement holder" would mean a person identified in the records of a securities intermediary as the person having a security entitlement against the intermediary. "Security entitlement" would mean the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5. "Securities intermediary" would mean either a clearing corporation or a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.

As a rule, a person would acquire a security entitlement if a securities intermediary did one or more of the following:

- Indicated by book entry that a financial asset had been credited to that person's securities account.
- Received a financial asset from the person or acquired a financial asset for the person and, in either case, accepted it for credit to the person's securities account.
- Became obligated under other law, regulation, or rule to credit a financial asset to the person's securities account.

If any of those conditions had been met, a person would have a security entitlement even though the securities intermediary did not itself hold the financial asset.

The bill states that, to the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that asset held by the securities intermediary would be held by it for the entitlement holders, would not be property of the intermediary, and would not be subject to claims of creditors of the intermediary, except as otherwise provided in the bill.

An entitlement holder's property interest with respect to a particular financial asset would be a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder

acquired the security entitlement or the time the intermediary acquired the interest in that asset. An entitlement holder's property interest with respect to a particular financial asset could be enforced against a purchaser of the asset or interest in it only if specific circumstances existed.

The bill would require a securities intermediary to do the following:

- Promptly obtain and maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it had established in favor of its entitlement holders with respect to that asset.
- Take action to obtain a payment or distribution made by the issuer of a financial asset.
- Exercise rights with respect to a financial asset if directed to do so by an entitlement holder.
- Comply with an entitlement order if the order were originated by the appropriate person, the intermediary had had reasonable opportunity to assure itself that the order was genuine and authorized, and the intermediary had had reasonable opportunity to comply with the order. ("Entitlement order" would refer to a notification directing transfer or redemption of a financial asset to which the entitlement holder had a security entitlement.)
- Act at the direction of an entitlement holder to change a security entitlement into another available form of holding for which the holder was eligible, or to cause the asset to be transferred to a securities account of the holder with another intermediary.

#### Choice of Law

The bill specifies that the law of the securities intermediary's jurisdiction would govern all of the following:

- Acquisition of a security entitlement from the securities intermediary.
- The rights and duties of the intermediary and entitlement holder arising out of a security entitlement.
- Whether the intermediary owed any duties to an adverse claimant to a security entitlement.
- Whether an adverse claim could be asserted against a person who acquired a security entitlement from the intermediary or a person who purchased a security entitlement

or interest in it from an entitlement holder.

The law of the jurisdiction in which a security certificate was located at the time of delivery would govern whether an adverse claim could be asserted against a person to whom the certificate was delivered.

The law of the issuer's jurisdiction would govern all of the following:

- The validity of a security.
- The rights and duties of the issuer with respect to registration or transfer.
- The effectiveness of registration or transfer by the issuer.
- Whether the issuer owed any duties to an adverse claimant to a security.
- Whether an adverse claim could be asserted against a person to whom transfer of a certificated or uncertificated security was registered or a person who obtained control of an uncertificated security.

MCL 440.1105 et al.

## **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

### **Supporting Argument**

Michigan's current version of Article 8 does not reflect the practices of the indirect holding system, or the legal rules under which it operates. The system in which actual certificates are delivered is essentially obsolete, and the anticipated system of uncertificated securities never developed to the extent that drafters had planned. Revised Article 8, on the other hand, accommodates practices that now exist, establishes clear rights and duties of securities intermediaries, identifies risks to investors, and provides understandable choice of law rules. By adopting Revised Article 8, the bill would establish a statutory framework for participants to function in today's securities market, and would promote unity among the states.

### **Supporting Argument**

Currently, a dual system governing securities exists in Michigan since recent regulations of the TRADES provide that Revised Article 8 governs U.S. Treasury securities and preempts the law of a state that has not adopted Revised Article 8. By adopting the revised article, the bill would eliminate this dual and inefficient system.

### **Supporting Argument**

Conforming amendments to Article 9 would set out the principal rules on security interests in investment property, and rely on concepts defined in Revised Article 8. Investment property refers to a category of collateral that includes securities, whether held directly or through intermediaries, and commodity futures. Previously, the rules concerning secured transactions of investment property had been included in Article 9, which governs security interests, but were moved to Article 8. The bill properly would return the governance of these transactions to Article 9.

Legislative Analyst: S. Lowe

### **FISCAL IMPACT**

The bill would have no fiscal impact on the Department of Consumer and Industry Services or on the Department of State.

Fiscal Analyst: M. Tyszkiewicz  
E. Limbs

A9798\S299A

This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.