Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries

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BEYOND NEGOTIABILITY: A NEW MODEL FOR TRANSFER AND PLEDGE OF INTERESTS IN SECURITIES CONTROLLED BY INTERMEDIARIES

Charles W. Mooney, Jr.

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This article examines some difficult issues concerning property rights that arise in modern securities markets and suggests some reforms of the legal regime. Current rules on the transfer and pledge of interests in securities, found in Articles 8 and 9 of the Uniform Commercial Code (U.C.C.)¹ and the federal regulations applicable to book-entry United States Treasury securities,² are cut from the familiar fabric of property law. However, as we shall see, traditional legal garments fit poorly on the frame of current practice.

Securities market participants typically eschew direct relationships with securities issuers and instead rely on financial intermediaries, such as stockbrokers and banks, to control their securities. This article focuses on transfers and pledges of interests in fungible bulks of securities that are controlled by intermediaries.³ The following example, of necessity somewhat complex but not unrealistic, illustrates some important relationships and issues involved.

¹ The American Law Institute, Nat'l Conference of Comm'rs on Uniform State Laws, Uniform Commercial Code: Official Text 1989 With Comments (11th ed. West 1989). The Uniform Commercial Code hereinafter is referred to as the U.C.C.; all citations to the U.C.C. are to the 1989 Official Text with Comments unless otherwise noted.


³ Throughout this article all references to an "intermediary" or "intermediaries" are intended to embrace securities firms (such as stockbrokers and securities dealers) as well as commercial banks who control securities on behalf of their customers.
in the transfer and pledge of these interests. The example is discussed throughout this article.

Example 1

Certain investors (C-1, C-2, C-3, and C-4) buy and sell securities through a securities firm intermediary, I-1. (I-1 might be a local or regional securities firm.) Because these customers are active traders rather than long-term investors, they allow I-1 to control their securities in order to facilitate rapid resale and to ensure that secured margin credit can be extended to them by I-1 from time to time. I-1 has many other customers (C-5 to C-5,000), each of whom claims securities of a much smaller value (in no case exceeding $500,000).

I-1 does not physically possess, nor is it the registered owner of any of the securities it controls for its customers. Rather, I-1 maintains a securities account with (i.e., is itself a customer of) another securities firm intermediary, I-2. (I-2 might be a national securities firm or a larger regional securities firm.) I-2 also does not possess, and is not the registered owner of, any of the securities it controls for I-1 (or for any of I-2's other customers). Instead, I-2 maintains a securities account with yet another intermediary, I-3. (I-3 might be a clearing corporation depository or a national securities firm.) On the books of the various securities issuers, I-3 is the registered owner of, and (in the case of certificated securities) is in physical possession of, all securities that I-3 controls for its customers. (Alternatively, if I-3 is a national securities firm, possession and registered ownership of the securities might be lodged with another intermediary, I-4, which is a clearing corporation depository.)

In order to finance its operations, I-1 obtains a loan from a bank lender, L. Collateral for this loan consists of securities issued by A Co. I-1 "pledges" these A Co. securities to L by causing I-2 to debit I-1's securities account and credit L's securities account on I-2's books.

Needing additional credit, I-1 obtains another secured loan, this time from I-2, and pledges securities issued by B Co., by instructing I-2 to debit I-1's securities account and to credit a special pledge account in I-1's name on the books of I-2.

I-1 becomes insolvent. C-1 (whose claims otherwise would not be satisfied) claims the A Co. securities and the B Co. securities that are pledged to L and I-2, respectively. L and I-2, of course, also claim these securities as secured creditors. The shortfalls in A Co. and B Co. securities (and the other shortfalls mentioned below) may have resulted from I-1's misbehavior or inadvertance.

C-2 and C-3 each claim securities issued by C Co. The C Co.
securities credited to I-1 in its account with I-2 are of a quantity that is sufficient to satisfy either C-2's claim or C-3's claim, but the quantity is insufficient to satisfy both of their claims.

C-4 claims securities issued by D Co. I-1 controls D Co. securities in its account with I-2 in the exact quantity necessary to satisfy fully C-4's claim.

I-1's other customers (C-5 to C-5000) claim securities of issues not claimed by C-1, C-2, C-3, or C-4. However, these customer claims reflect a similar pattern. In some cases I-1 controls sufficient securities to cover customer claims to securities of the issue involved. In other cases there is a shortfall.

The following diagram illustrates the relationships involved in Example 1.

Note that L, I-2 and each of I-1's customers have claims to securities as a result of transactions with the same party, I-1. But their claims are based on entries on the books of two different intermediaries—I-2 and I-1. I-3 has a relationship with I-2, but has no relationship with I-1 or L. I-2 has a relationship with I-1 and L, but has no relationship with any of I-1's customers. Note also that in these arrangements the securities involved are controlled by the intermediaries in a "fungible bulk."*4

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*4 An intermediary (such as I-1) may control securities by maintaining an account with another, upstream, intermediary (such as I-2). Or, an intermediary (such as I-3) may have physical possession of securities held in "street name." "Street name" generally refers to the practice of securities intermediaries who hold fungible bulks of securities in their own names,
Example 1 raises several obvious questions. For example, why have various parties chosen to receive interests in securities through intermediaries who continue to control the securities (through other intermediaries), rather than taking physical delivery of certificates indorsed or registered to them? Part I of this article addresses these questions by introducing some important transactional patterns in the securities markets and the roles of securities intermediaries. It also addresses the risks inherent in such a market structure and the various legal approaches that serve to reduce or manage those risks.

How will C-2 and C-3 share in the insufficient quantity of C Co. securities? Given that shortfall, will C-4 be permitted full satisfaction because J-1 controls a sufficient quantity of D Co. securities to satisfy C-4's claim? The same questions can be asked about the similar conflicting claims of J-1's other customers. These and related questions are addressed in Parts II and III, which consider how current law deals with conflicting property claims—which I call "same-tier" claims—of claimants (such as C-1, C-2, C-3, and C-4) who claim through accounts with a common intermediary (such as J-1). Part II examines the existing statutory framework for transfer and pledge of interests in securities as well as relevant priority rules. Part III considers the treatment of claims to securities when an intermediary becomes insolvent.

Who is senior as to the A Co. securities claimed by C-1 and L and the B Co. securities claimed by C-1 and J-2? Will the answer depend on who obtained a property interest first-in-time? Did L, J-2 or C-1 achieve the status of a bona fide purchaser and thereby cut off claims that arose earlier-in-time? Part IV explores these competing claims to securities by transferees who claim through accounts with different intermediaries—which I call "different-tier" claims.

Part V develops the central thesis of this article—that a property law construct for resolving priorities among claimants to fungible bulks of securities is a fundamentally flawed approach. The property interest received by a purchaser on the books of its securities intermediary bears little resemblance to the property interest resulting from a physical delivery of a certificated security or registration on the books of an issuer. The interest of an ownership claimant through an intermediary is best characterized as a bundle of rights against the intermediary. The "property" involved is the claimant's interest in its...
account with its intermediary, not the fungible bulk of securities that may or may not underlie that account. If the intermediary remains financially viable, the claimant obtains the indirect benefits of ownership of the securities. If the intermediary fails, the claimant has a priority claim, shared ratably with other similarly situated claimants and measured by a fungible bulk of securities that may or may not be sufficient to satisfy those claims. Nevertheless, in many important respects the existing legal regime dealing with transfer, pledge, and priorities among claimants to interests in securities—principally U.C.C. Article 8—is grounded on a distorted perception. It contemplates that claimants are owners of discrete property in the possession or control of bailee-agents. This distorted characterization promotes unnecessary costs, uncertainty, and arbitrary and fortuitous results. Existing law has resulted in confusion and misunderstanding among scholars, practitioners, and courts alike.

Earlier and ongoing law reforms have not embraced the more accurate conceptualization of transfers of securities controlled by intermediaries suggested here. The revisions to Article 8 that resulted in the 1978 Official Text of the U.C.C. served primarily to provide a statutory framework for the transfer and pledge of uncertificated securities. This effort was worthwhile, but in the larger context of securities market operations the potential for a certificateless society may turn out to be merely a detail. Market participants recognize

3 See U.C.C. app. 1 at 934 (1989) (Reporter's Introductory Comment) [hereinafter Reporter's Comment] (“What the revision is intended to accomplish is to set forth a coherent group of rules for the issuers, buyers, sellers and other persons dealing with uncertificated securities, to the same extent that present Article 8 deals with these matters with respect to certificated securities.”). For descriptions of the background and development of the 1977 amendments to the U.C.C., which resulted in the 1978 Official Text, see Aronstein, Haydock & Scott, Article 8 in a Ready, 92 Harv. L. Rev. 889, 890-93 (1980); Coogan, Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code, 92 Harv. L. Rev. 1013, 1017-22 (1979). Because the 1987 Official Text of the U.C.C., which added Article 2A, and the 1989 Official Text, which added Article 4A, made no changes to Article 8, the version of Article 8 in both the 1978 and 1989 Official Texts hereinafter will sometimes be referred to as the 1978 Article 8. The identical versions of Article 8 in the 1962, 1966 and 1972 Official Texts hereinafter will be referred to as the pre-1978 Article 8. A version of the 1978 Article 8 has been enacted by 37 states as of September, 1990. [State Correlation Tables] U.C.C. Reg. Serv. (Columbia).

6 Even before the 1978 Article 3 was promulgated the "paperwork crunch" that inspired the revision of Article 8 was substantially resolved by the development and widespread use of a central depository system and enhanced methods of clearing and settling securities trades. See Committee on Stock Certificates, Section of Corporation, Banking & Business Law, American Bar Association, Report of the Committee on Stock Certificates at 37-43 (1973) [hereinafter ABA Report]; Aronstein, Haydock & Scott, supra note 3, at 890-91; Aronstein, A Certificateless Article 8? We Can Have It Both Ways, 31 Bus. Law. 727, 728-30, 732-35 (1976) [hereinafter Both Ways]. The legendary "paperwork crunch" in the securities markets during the late 1950's was the primary impetus for the ABA project that eventually resulted in promulgation
not only that deliveries of negotiable paper reflecting each market transaction are intolerable, but also that routine market transactions must occur without changes in registered ownership on the books of securities issuers or their transfer agents. In Example 1, where fungible bulks are involved, it is of no real consequence whether I-3 is in possession of certificated securities or is, instead, the registered owner of uncertificated securities. Although the role of intermediaries is central to market structure and operation, the 1978 Article 8 offered no new conceptual framework to take account of transfers on the books of an intermediary. It remains wedded to a property law construct even when fungible bulks are concerned. The same can be said of the proposed federal regulations that would (when and if issued) cover transfer and pledge of book-entry Treasury securities (the Proposed TRADES Regulations). 7

Part V of this article offers an alternative to a property law construct. It suggests a new model for dealing with transfer and pledge of interests in fungible bulks of securities controlled by intermediaries. A new model would focus on the relationships of claimants to intermediaries rather than property law constructs such as identification and tracing of property, first-in-time-first-in-right, and bona fide purchase. A new model is illustrated by a proposed priority rule for resolving different-tier claims: “upper-tier priority.” Claimants against a securities intermediary could look only to that intermediary for satisfaction (subject, of course, to sharing rules applicable to same-tier claimants). Lower-tier claimants (such as C-1) generally would have no senior claims to securities or other rights as against upper-tier intermediaries (such as I-2) or transferees (such as L) who claim of the 1978 Article 8. See, e.g., Aronstein, Both Ways, supra, at 727. A considerable volume of commentary was addressed to prospects for a “certificateless society” during the 1970’s. See, e.g., id.; Aronstein, The Decline and Fall of the Stock Certificate in America, 1 Comp. L. & Sec. Reg. 273 (1978); Guttman, Toward the Uncertificated Security: A Congressional Lead for States to Follow, 37 Wash. & Lee L. Rev. 717, 719 (1980); Mulhern, First Steps Toward a Certificateless Society Under Existing Law: One Practitioner’s Experience, 26 Bus. Law. 617 (1971); Smith, A Piece of Paper Revisited, 26 Bus. Law. 1769 (1971); Smith, A Piece of Paper, 25 Bus. Law. 923 (1970) [hereinafter Smith, Piece]; Steadman, The Lender in the Certificateless Society, 26 Bus. Law. 623 (1971); Werner, The Certificateless Society: Why and When?, 26 Bus. Law. 605 (1971).

through accounts with such upper-tier intermediaries. The merits of this upper-tier priority rule are supported by economic analysis and by analogous priority rules under the U.C.C. An upper-tier priority rule would neither pit the rich against the poor nor the large and sophisticated against the small and unsophisticated. Pursuant to the Securities Investor Protection Act (SIPA), nonfinancial institution customers of insolvent securities broker-dealers generally are protected against losses up to $500,000 per customer by the Securities Investor Protection Corporation (SIPC).  

Consideration of this priority rule suggests a new way of thinking about what it means to become a purchaser of securities through an intermediary. Even if upper-tier priority is rejected as unsound, the fact remains that modern securities markets have moved so far beyond the movement of pieces of negotiable paper that the property law construct is inadequate and unworkable. Whatever rules might emerge, there is a need to push the legal regime "beyond negotiability" and, perhaps, "beyond property."  

Legal scholars of commercial and property law have paid relatively scant attention to the important subject of transfer and pledge of securities in modern securities markets. Even those who have focused their attention on securities market operations have rarely delved into the matters of transfer and pledge. This article seeks to inspire greater scholarly attention to these matters.

Actual litigation concerning the priority contests considered here has not, and probably will not, often occur. Does this mean that these defects in the property law construct of existing law are merely of academic and theoretical interest? My answer is "no"—with one

8 See generally Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. §§ 78aaa-78lll (1988); infra notes 163-67 and accompanying text. The $500,000 cap includes claims for cash not exceeding $100,000. 15 U.S.C. § 78fff-3(a)(1) (1988). Moreover, many securities firms have obtained private insurance affording additional protection to customers, typically in the amount of $2,500,000. See R. Teweles & E. Bradley, The Stock Market 319 (5th ed. 1987). This article generally is concerned with the rights and claims of market participants who are not eligible for, or whose claims exceed, such protection rather than smaller, probably less sophisticated investors.

9 Observers have long recognized the flaws of market dependency on delivering and processing paper securities certificates. See supra note 6. For a fascinating description of the tortuous route of securities certificates, which was routine before development and widespread use of the securities depository system, see Smith, Piece, supra note 6. The legal regime does not yet contemplate the full implications of a system dependent on intermediary control of fungible bulks.

10 One exception is Egon Gutman. See Gutman, supra note 4. However, as with any broad treatment that is intended to canvass the state of the law, Gutman's treatise does not always accommodate extensive theoretical explorations more compatible with articles in scholarly journals.
possible caveat mentioned below. Ex ante, the applicable legal treatment casts a continuous shadow over how market participants (including extenders of secured credit that is vital to the market) approach and structure their transactions and relationships. Moreover, government regulators of securities intermediaries and bank lenders must take loss allocation rules into account in order to assess the exposure and prudence of those regulated entities. Some evidence of the significance of these issues is provided by the serious study and consideration they are receiving from lawmakers, regulators and within the securities industry. Perhaps this article will assist and influence those who are positioned to change the law.

The problem is not only that current law can lead to a “wrong" result. The nub of why the issues addressed here actually matter is the prevailing uncertainty of outcome under current law. This uncertainty derives largely from the inherently poor fit between a property law construct and the nature of fungible bulks of securities controlled by intermediaries in today’s marketplace. The limited case law and commentary indicate that there are wide areas of disagreement, even as to results that ought to be clear enough under current law. Moreover, it will be shown that any future changes in commercial law probably will fail to enhance certainty and predictibility if they cling to the existing property law construct.

The caveat mentioned above is this: Is the existing uncertainty significant enough to warrant serious attention? Few would argue

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11 The Proposed TRADES Regulations under consideration by the Department of Treasury have been mentioned. See supra note 7. In addition, at the request of David Ruder, then Chairman of the Securities and Exchange Commission (SEC), a special Advisory Committee (on which I serve) of the American Bar Association Section of Business Law is studying these issues, among others. That committee is in the process of finalizing a report that will make recommendations concerning many of the issues discussed in this article. See Advisory Committee on Settlement of Market Transactions, Section of Business Law, American Bar Association, Investment Securities Under U.C.C. Article 8: Selected Issues Concerning Scope, Transfer, Security Interests and Priorities (Draft of Aug. 24, 1990) [hereinafter ABA Draft Report].

with the general proposition that certainty and predictability in commercial and property law are desirable. Yet few would think that even great uncertainty as to a trivial matter would warrant the time and attention necessary for a fix. This article embraces the apparent consensus that the existing state of the law concerning transfer and pledge is indeed a serious problem warranting serious attention.\footnote{See, e.g., ABA Draft Report, supra note II (recommendations concerning security interests in "securities accounts"; treatment of security interests in securities and repos in bankruptcy; "same-tier" sharing among ownership claimants, secured creditors, and repo parties; warranties made by securities intermediaries; choice of law issues; priorities among "different tier" claimants (suggesting "serious consideration" be given to the upper tier priority proposal made in this article); and foreign custodians for clearing corporations).}

The value of securities traded and financed and the potential for chain reaction "system risk" affecting a large number of financial institutions is enormous. Although the routine procedures for settlement of securities trades and secured financing of securities market participants may function well enough in normal conditions, recent market events—the October 1987 "market break" and the bankruptcy filing by the parent corporation of Drexel, Burnham, Lambert, Inc.—have illustrated the potentially severe consequences of prevailing uncertainties in the legal regime.\footnote{In both instances bank lenders were reluctant to extend credit necessary to provide vital liquidity because of uncertainty as to perfection and priority of security interests in collateral. See Division of Market Regulation, U.S. Securities and Exchange Commission, The October 1987 Market Break 10-57 (1988); The Issues Surrounding the Collapse of Drexel Burnham Lambert: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 101st Cong., 2nd Sess. 49-50 (1990) (statement of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission).}

Finally, the thesis of this article may have broader implications for loss allocation in contexts unrelated to the securities markets. Loss allocation based on a property law construct seems to make sense in an environment where claimants can feasibly determine that they will receive and continue to maintain their bargained-for property interests. In other environments, such as transfers of interests in fungible bulks of securities controlled by intermediaries, those determinations cannot be made. Allocating loss based on doctrines such as tracing, first-in-time and bona fide purchase makes little sense in these contexts.\footnote{For a general discussion of principles of property law imbedded in the U.C.C., see Dolan, The U.C.C. Framework: Conveyancing Principles and Property Interests, 39 B.U.L. Rev. 811 (1979). Dolan identifies three "conveyancing rules": (i) "security of property," or the "shelter principle," whereby a transferee receives all of its transferor's interest, and the close relative of "shelter," nemo dat quod non habet, whereby a transferee cannot transfer a greater interest than it has; (ii) "good faith purchase," whereby a transferor can transfer more than it has; and (iii) the "Pyne rule," whereby a transferee receives less than its transferor has. Id. at 811-819.}

This discussion may offer insights for other areas of com-
cmercial law that are ill-suited for loss allocation through a property law construct. 15

I. Securities Controlled by Intermediaries

A. The Roles of Intermediaries in Securities Markets

In order to participate in the securities markets, investors must use market professionals. The most familiar role of a securities intermediary is that of the broker who, through a seat on an exchange or as a participant in an "over-the-counter" (OTC) market, buys and sells securities on behalf of its clients as well as for its own account. Moreover, many investors in the securities markets normally allow intermediaries to maintain continued control of their securities. The convenience and enhanced liquidity are obvious for active traders 16 who maintain accounts with an intermediary who controls the securities. However, this intermediary control phenomenon reflects more than mere convenience for active investors; it is an essential element of their participation in the market. Consideration of clearing and settlement of securities trades illustrates why this is so.

1. Clearing and Settlement

"Clearing and settlement" comprise the process that occurs after securities trades (agreements to sell and buy) are made. 17 "Clearing" is the process whereby the trades are compared, matched, and confirmed. 18 "Settlement" is the process whereby parties to trades fulfill

15 See, e.g., Rogers, The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System, 65 Tex. L. Rev. 929 (1987) (arguing that property law concepts in negotiability doctrine are inappropriate for the check collection system) [hereinafter Rogers, Irrelevance]; see also Rogers, Negotiability, Property, and Identity, 12 Cardozo L. Rev. 471 (1990) [hereinafter Rogers, Negotiability]; Rogers, The Myth of Negotiability, 31 B.C.L. Rev. 265 (1990) [hereinafter Rogers, Myth]. Consideration now being given to the prospects for dematerialization, through electronic data interchange, of letters of credit, documents of title, and documentary data also may be informed by the discussion here. See 2 U. S. Council on International Banking, Inc. News, Jan. 1990, at 1, col. 2 (establishment of working groups by the International Chamber of Commerce to address these matters in connection with the revision of International Chamber of Commerce Publication No. 400, "Uniform Customs and Practice for Documentary Credits").

16 Because the intermediary controls the securities, the customer can ask the intermediary to sell the security without the need to deliver to the intermediary a certificate and a signature guarantee in form for "good delivery." See ABA Report, supra note 6, at 27-30; see also Gutman, supra note 4, at 3-31 to 3-34 (discussing market practices concerning "good delivery." ). The convenience also is important to many less active investors, including individual investors.

17 See generally 1 Office of Technology Assessment, Study of International Clearing and Settlement 3-4 (1989) [hereinafter OTA Study]; Stigum, Trade, supra note 4, at 121-22.

18 OTA Study, supra note 17; Stigum, Trade, supra note 4.
their obligations thereunder—a generally a “delivery” of the securities by the seller and payment of the agreed price by the buyer. Two principal systems of clearing and settlement in the United States securities markets today illustrate the process.

a. The DTC-NSCC System

Most of the trades in corporate equity and debt securities made on the major United States securities exchanges and OTC markets are cleared and settled, directly or indirectly, in a system involving the combined services of two registered clearing agencies, The Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC). The system is NSCC’s Continuous Net Settlement

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19 OTA Study, supra note 17; Stigum, Trade, supra note 4.
20 In securities industry parlance “delivery” refers to the completion of a transferor’s obligation with respect to transfer of an interest in securities, but does not necessarily mean an actual physical delivery. For example, transfers of book-entry (uncertificated) securities, transfers on the books of securities depositories, and credits to accounts of securities intermediary customers are referred to as deliveries.
21 More precisely, it is the process whereby the actual parties to trades made on exchanges and in over the counter (OTC) markets deliver and pay each other. Brokers usually act as agents for undisclosed principals and thereby become obligated on trades to buy or sell, as the case may be. See Guttman, supra note 4, at 8-17, n.67 (citing Restatement (Second) of Agency § 321 (1958)). Thus, clearing and settlement on the wholesale level deals with delivery and payment as among the participating securities intermediaries.
22 Unless otherwise noted, the following discussion of the process of clearing and settlement is based on Stigum, Trade, supra note 4, at 77-145, 245-57; R. Teweles & E. Bradley, supra note 8, at 174-79. While the discussion is adequate for present, essentially contextual, purposes, it is oversimplified in many respects and much detail is omitted.
23 DTC, a New York limited purpose trust company, is the world’s largest securities depository. The Depository Trust Co., Annual Report 1989 at 11, 35 (1990) [hereinafter DTC 1989 Report]. It was formed in 1973 as a successor to the business of the New York Stock Exchange’s Central Certificate Service, which was created to respond to the paperwork crunch of the late 1960s. Id. at 6. DTC is owned by its securities firm and bank participants. Id. at 11. At year-end 1989, DTC maintained securities accounts for 696 participants (408 brokers-dealers, 189 banks, and 9 clearing agencies). Id. at 3. “Indirect participants,” securities intermediaries that are correspondents of (i.e., customers of) DTC participants, totalled more than 4,000 during 1989. Id. at 28. (If, in Example 1, I-3 were DTC, then I-2 would be a direct participant and I-1 would be an indirect participant.) During 1989 74 million DTC book-entry transfers of securities with a total value of $9.2 trillion were made. Id. at 10. At year-end 1989 there were deposited with DTC eligible securities valued at $4.02 trillion, consisting of 116.5 billion equity shares, corporate debt (principal amount) of $1.017.3 billion, and municipal debt (principal amount) of $750.9 billion. Id. at 3. These deposited securities constitute about 72% of all shares of companies represented in the Dow Jones Industrial Average, about 85% of all shares of New York Stock Exchange-listed companies, about 43% of all shares of NASDAQ and American Stock Exchange-listed companies, and about 85% of the principal amount of all outstanding municipal bonds. Id. at 9.
24 NSCC was formed in 1977 to provide posttrade clearance and settlement services for trades on the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) and National Association of Securities Dealers (NASD) OTC market; NSCC is owned jointly by the NYSE, AMEX, and NASD. R. Wolow, An Overview of the Role of the National
(CNS) system. Only trades in securities eligible for deposit with DTC can be cleared and settled in the CNS system, and on the settlement date all of the securities to be delivered must be on deposit with DTC. Prior to the settlement date the trades among all of the participants are compared (matched) and netted with respect to each securities issue, with each participant ultimately becoming obligated to transfer or entitled to receive only a net quantity of securities that takes into account all of that participant's trades in that security issue. Also prior to the settlement date, NSCC becomes obligated to transfer and entitled to receive these netted amounts of securities to or from each participant. On the payments side, all amounts to be paid and received by each broker-dealer participant also are netted, and NSCC becomes obligated to pay and entitled to receive payment to or from each participant. Each participant becomes obligated to pay to


For a general description of the CNS (and other) clearing and settlement systems operated by NSCC, see Woldow, Overview, supra note 24, at 9-16.

In the corporate equity and bond markets trades are settled on the fifth business day following the trade date by the broker-dealer intermediaries involved in the trade ("street-side settlement"). By the settlement date, customers of DTC participants also are required to pay their intermediaries for securities being purchased ("customer-side settlement"). These payments from customers to their DTC participant intermediaries take place outside the DTC-NSCC process. Most large, active institutional investors have the privilege of "delivery versus payment"—that is, they are not obliged to pay the intermediary who is to control the securities for them until the securities have been "delivered" to the intermediary. DTC's Institutional Delivery (or ID) System effectively connects the street-side and customer-side settlements for participating institutional investors. See infra note 33. Changes and enhancements of the CNS clearance and settlement system and the ID System will be required if the United States markets are to meet the 1992 target for compliance with two of the G-30 recommendations: Settlement on the third (instead of the fifth) business day following the trade date and money settlement with same-day (instead of next-day) funds. See G-30 Report, supra note 11, at 13-15.

This is the concept of "multilateral netting." See Stigum, Trade, supra note 16, at 246-47. Prior to settling, the process of "comparison" takes place. Buyers' and sellers' trade confirmations are compared in order to detect and modify or eliminate transactions where a buyer's and seller's records do not agree. This process is highly automated.

Because NSCC is deemed to come between all parties to trades for purposes of netted
or entitled to receive from NSCC only a single sum on account of all of its trades for all issues to be settled on that date. In sum, on each settlement date, each NSCC participant pays to or receives one sum of money from NSCC and each NSCC participant transfers to or receives from NSCC, by book entry on the books of DTC, a single quantity of each security issue involved.

Most large institutional investors employ a DTC participant custodian bank. Most of these investors allow their custodian banks to leave their securities in the custodian banks’ accounts with DTC, registered in the name of DTC’s nominee, although in theory the inves-

30 This is the concept of “multi-issue” netting. See Stigum, Trade, supra note 4, at 247.
31 In its role as a securities depository, DTC effects transfers of securities among its participants by debits and credits to their securities accounts on the settlement date. NSCC is a DTC participant. On the settlement date, participants who are net transferors of securities of a given issue transfer securities to NSCC on DTC’s books and participants who are net transferees of such securities receive transfers from NSCC on DTC’s books.
32 This method of settlement involves obvious credit risks for the participants since NSCC’s ability to deliver securities and make payments depends on its receipt of securities and payments from participants. The novation netting, however, reduces the aggregate amount of each participant’s obligations. In the case of a payment default arising from a participant insolvency, NSCC maintains a fund of participant deposits designed to ensure that settlement will take place even in the face of such a default. See Stigum, Trade, supra note 4, at 253; Woldow, Overview, supra note 24, at 19-20. In the event the fund were to be insufficient, participants share the risk as they are subject to additional pro rata assessments to make up any shortfall. Id.; NSCC 1989 Report, supra note 24, at 19. In the case of routine failures to deliver securities, in the CNS delivery obligations are continually deferred to the next settlement date (by netting with deliveries to be made on that settlement date) and “marked to market” so as to adjust for price changes. See Guttman, supra note 4, at 8-19; Stigum, Trade, supra note 4, at 252. In theory, however, the potential for “systemic risk” exists if a large default were to result in defaults by other participants. See, e.g., Board of Governors of the Federal Reserve System, Controlling Risk in the Payments System, Report of the Task Force on Controlling Payments System Risk to the Payments System Policy Committee of the Federal Reserve System 9 (1988) [hereinafter Payments Task Force Report].

33 DTC’s Institutional Delivery (ID) System involves the relationship between an institutional investor and its custodian bank and broker. The ID System connects the investor to the automated communications process for clearing and comparing trades. For descriptions of the ID System, see generally DTC 1989 Report, supra note 23, at 30-31; Stigum, Trade, supra note 4, at 254-55. Rules of the NYSE, AMEX, and NASD now require institutional investors to settle trades through an institutional delivery system (such as the ID System) through a registered clearing agency (such as DTC). See AMEX Rule 423 (rev. ed. 1982); NASD Unif. Proc. Code, § 64 (rev. ed. 1988); NYSE Rule 387 (rev. ed. 1983).
34 See DTC 1989 Report, supra note 23, at 30. Securities deposited with DTC normally are registered in the name of its nominee, Cede & Co. (a partnership controlled by DTC, the sole function of which is to maintain registered ownership of securities deposited with DTC). DTC collects and distributes to its participants amounts paid by issuers as dividends, principal and interest. DTC also provides information on participant beneficial ownership to issuers who can then communicate directly with the participants concerning matters such as voting rights. The participants, in turn, communicate with their own customers. Id. at 22-23. Were the securities not a part of a fungible bulk, much of the benefit of the intermediary control
tors could request their DTC member-intermediary to withdraw and hold them or request that certificates be issued in the investors' own names.\textsuperscript{35} Thus, these market participants normally have no direct relationship with the issuers of securities of which they claim beneficial ownership. DTC participants expect DTC's nominee to become the registered owner of securities, and non-participant investors, in turn, look to the DTC members or other intermediaries.

Eliminating or reducing reliance on securities certificates and moving toward a world of uncertificated securities\textsuperscript{36} would be useful and could reduce costs.\textsuperscript{37} But the role of the depository system in clearing and settling securities trades has achieved more than merely reducing the physical movement of securities certificates among the market participants. Even if uncertificated securities became the norm, that probably would have no fundamental impact on the most important characteristics of securities market operations. DTC's nominee would continue to be the registered owner of the uncertificated securities (although freed from the costs of maintaining physical control of certificates), and the propensity of market players to claim through intermediaries would not be abated.\textsuperscript{38}

phenomenon would evaporate. For example, the benefits of netting in the DTC-NSCC clearing and settlement process depends on the inherent fungibility of securities on deposit with DTC. See supra notes 25-32 and accompanying text.

\textsuperscript{35} See Stigum, Trade, supra note 4, at 255 ("When a custody bank takes delivery of securities for a [sic] institutional customer, the normal procedure and the one DTC prefers is that the custody bank leave those securities in DTC's vault."). Not only would routine withdrawal of certificates result in additional costs, but it would make no sense for many active traders. Because the securities ultimately must be in DTC's control for purposes of clearing and settlement, continual withdrawals would result in an intolerable loss of liquidity.

\textsuperscript{36} See supra note 5.

\textsuperscript{37} The principal savings from eliminating certificates would relate to DTC's costs of physical storage, retrieval, deposit and withdrawal of certificates for participants' customers. The deposit and withdrawal operations would remain necessary with uncertificated securities in order to confer registered status on those beneficial owners who desire it. See infra note 82 (registration of transfer of uncertificated securities under 1978 Article 8). As between DTC and securities issuers, however, eliminating certificates would allow many of these operations to be achieved electronically. Even without actually eliminating paper certificates, the successful development by DTC of the "book entry only" (BEO) system for securities issuance and transfer has resulted in substantial savings for securities issuers. BEO securities involve only one "global" certificate per issue to be held by DTC. Neither BEO certificates nor registered ownership are available to investors. DTC 1989 Report, infra note 23, at 28. About 40% of all municipal debt issued during 1989 involved BEO securities. Id. Additional cost reductions have been achieved through DTC's Fast Automated Securities Transfer (FAST) System, in which "balance certificates" are left with issuers' transfer agents, with daily adjustments in balances; thereby further reducing the movement of physical certificates. See id. at 17.

\textsuperscript{38} Interview with Richard Nessen, General Counsel, The Depository Trust Company, in New York City (July 6, 1988).
b. Government Securities—Fedwire and the 
“Clearing Bank” System

United States Treasury securities are virtually all uncertificated (book-entry), yet the market reflects the same propensity for intermediary control. Book-entry Treasury securities are subject to a “tiered” system of ownership and transfer established by Treasury Department regulations. Only a “depository institution” (DI) can

39 As of December 31, 1985, 97% of the outstanding principal amount of marketable United States Treasury securities were in book-entry form. See Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills, Summary of Department of Treasury, 51 Fed. Reg. 8846 (proposed March 14, 1986) (To be codified at 31 C.F.R. pt. 357) [hereinafter March TRADES Summary]. Since 1978 Treasury bills have been issued only in book-entry form, and since July 1, 1986 all Treasury securities have been issued only in book-entry form. Id. Securities issued by various Federal agencies with full or partial guaranties by the United States government also are issued in book-entry form. See infra note 126 (citing relevant regulations applicable to such agency securities). The following discussion generally applies to such agency book-entry securities as well as to book-entry Treasury securities. One important type of Federal agency security, “mortgage-backed pass-through” securities guaranteed by the Government National Mortgage Association (usually called “Ginnie Mae”), is not issued in book-entry form, and clearing and settlement for Ginnie Mae continues to involve physical deliveries and registration and reissuance in the name of beneficial owners. See generally Stigum, Trade, supra note 4, at 151-68, 263-78. A new system for Ginnie Mae clearing and settlement is emerging. In that system Participants Trust Company (PTC), a New York limited purpose trust company, functions as a securities depository and MBS Clearing Corporation (MBSCC) performs trade recording, comparison, and netting services. See generally Self Regulatory Organizations; Participants Trust Company; Order Granting Registration as a Clearing Agency and Statement of Reasons, Exchange Act Release No. 26,671, 54 Fed. Reg. 13,266 (March 31, 1989) (PTS System) [hereinafter PTS System]; Self Regulatory Organizations, MBS Clearing Corporation, Order Granting Registration as a Clearing Agency and Statement of Reasons, Exchange Act Release No. 24,046, 52 Fed. Reg. 4218 (Feb. 10, 1987) [hereinafter MBSCC System]. Clearing and settlement in the PTC-MBSCC system will be similar to the DTC-NSCC system in many respects. See PTS System, supra; MBSCC System, supra.


41 See 31 C.F.R. §§ 306.115-306.122, 350.2-350.6 (1980). The Department of Treasury has described the system as follows:

Assume that an individual ("Individual Investor") has invested in a Treasury 5-year note through a local government securities dealer ("Local Dealer"). Local Dealer is maintaining one or more Treasury 5-year notes of the same issue through another book-entry custodian such as a larger government securities dealer ("National Dealer"). National Dealer would most likely be maintaining the 5-year notes through a bank ("Clearing Bank"). Clearing Bank would be maintaining the 5-year notes directly in an account at a Federal Reserve Bank. Each of the book-entry custodians will record on its books securities maintained for the account of the book-entry custodian below it in the chain, and local dealer will record on its books the interest of Individual Investor.
attain a status equivalent to that of a registered owner on the books of
a Federal Reserve Bank. Thus, an active trader of book-entry
Treasury securities, that is not itself a DI, can only obtain an interest
in securities through an account with an intermediary (either a DI or
another downstream intermediary). Just as direct participation in
DTC is limited to its financial institution members, only DIs have
access to securities accounts on the books of the Fed.

It follows that clearing and settlement in the book-entry Treasury
securities market necessarily involves the participation of DIs. Most trades are cleared and settled for the principal government securities dealers and brokers by only three banks, known in this con-
text as “clearing banks.” Instead of settling on a netted basis on a
day following the trade date, book-entry Treasury securities are trans-
ferred against payment on a real-time, continual basis throughout
each business day. These practices are made possible by the Fedwire
system. A participating DI can transfer securities electronically on
Fedwire to another DI and simultaneously receive payment from the

March TRADES Summary, supra note 39, at 8846.

Treasury regulations applicable to book-entry Treasury securities, as written, contemplate that only a “member bank” (defined as a member of a Federal Reserve Bank) can maintain a book-entry securities account with a Federal Reserve Bank. See 31 C.F.R. §§ 306.115(g), 306.117(a) (1990). However, those privileges have been extended by the various Federal Reserve Banks to all depository institutions. Telephone interview with Stephen Smith, Federal Reserve Bank of New York (October 11, 1989); see 12 U.S.C. § 461(b)(1)(A) (1988) (defining “depository institution” essentially as an entity eligible to apply for federal deposit insurance).

Transfer and pledge of interests in book-entry Treasury securities under the Book-Entry Treasury Regulations is discussed infra text at notes 125-54. Investors who do not require the flexibility of intermediary control, such as individuals that desire to hold securities for long periods, now have the option of establishing a book-entry security account directly with the Department of Treasury. See 31 C.F.R. §§ 357.20 - 357.32 (1990) (regulations dealing with the Treasury Direct system).

The various Federal Reserve Banks are referred to as the Fed.

The market for Treasury securities is an OTC market. See generally GAO Report, supra note 40, at 18-32.

Prior to the combination of The Bank of New York and Irving Trust Company, there were four “clearing banks”: Manufacturers Hanover Trust Company, The Bank of New York, Irving Trust Company, and Security Pacific National Bank. Stigum, Trade, supra note 4, at 122-24. One clearing banker estimated that the top three clearing banks clear securities trades of more than $300 billion per day on average. Id. at 124-25.

Fedwire is a computerized communications system operated by the Federal Reserve System for the transfer of funds and book-entry Treasury and federal agency securities among participating DIs. See Federal Reserve System Regulation J, 12 C.F.R. §§ 210.35-210.38 (1980) (wire transfers of funds); Federal Reserve Bank of New York Operating Circulars Nos. 21 (Book-Entry Securities) (rev. 1977); 21A (On-Line Transactions in Book-Entry Securities (rev. 1988). Other Federal Reserve Banks have operating circulars that are substantially the same as Operating Circulars 21 and 21A. For a description of the Fedwire system see Stigum, Trade, supra note 4, at 109-20.
The Fedwire system involves enormous extensions of intra-day credit, in the form of overdrafts, by the clearing banks to the brokers and dealers. When a dealer’s clearing bank receives securities against payment the dealer often does not have enough in its account with the clearing bank to pay the clearing bank, thereby creating an overdraft in the dealer’s account. During the day the Fed, in turn, must extend overdraft credit to the clearing banks. A clearing bank looks to securities received and allocated to the dealer’s “clearing account” as collateral for this daylight overdraft credit. Before the end of the day, the dealers expect to receive funds, mostly from instructing the clearing bank to transfer securities over Fedwire against payment, so as to

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48 Fedwire permits a participating DI to transfer securities to another participating DI against payment. Federal Reserve Bank of New York Operating Circular 21A, para. 7. Although these transfers are final, it necessarily follows that the recipient simply could reverse the transaction by sending the securities back to the transferor against payment. Fedwire also accommodates so-called “free transfers,” not made against payment, as well as “funds only” transfers not involving securities. See Stigum, Trade, supra note 4, at 105-08.

49 The dollar amounts involved are staggering. In 1988 the average daily peak overdrafts (based on two week averages) with the Fed attributable to receipt of book-entry securities against payment, for all DIs, were almost $60 billion. Board of Governors of the Federal Reserve System, Recommendations of the Payments System Policy Committee 18, 35 (1989) [hereinafter Policy Committee Recommendations]. Presumably, most of these overdrafts were incurred by the most active clearing banks. See Reserve City Bankers Report, supra note 40, at 20-21 (estimating that more than 75% of average daily book-entry overdrafts were attributable to the five largest clearing banks). Officials in the Federal Reserve System have expressed much concern about the amount of these (as well as non-book-entry securities related) daylight overdrafts. See Board of Governors of the Federal Reserve System, Modifications to the Payments System Risk Reduction Program; Book-entry Securities Transfers, Docket No. R-0669, 55 Fed. Reg. 22,087 (May 31, 1990) (adopting proposal that DI’s funds and book-entry overdrafts be combined for purposes of compliance with net debit cap, adopting modified proposal for collateralization of certain overdrafts, and adopting procedures for collateralization); see also Payments Task Force Report, supra note 32; Board of Governors of the Federal Reserve System, A Strategic Plan for Managing Risk in the Payments System, Report of the Large Dollar Payments System Advisory Group to the Payments System Policy Committee of the Federal Reserve System (1988). In part because of the Fed’s concerns about daylight overdrafts, the Government Securities Clearing Corporation (GSCC), a subsidiary of NSCC, has developed a system to introduce the benefits of multilateral netting among principal government securities market participants. See Stigum, Trade, supra note 4, at 257-62. Such a netting scheme could substantially reduce transfers of book-entry securities over Fedwire and, consequently, reduce overdrafts. In 1988 GSCC began operation of automated comparisons of government securities trades and in 1989 it began implementation of a netting scheme. See Self-Regulatory Organizations; Order Approving Proposed Rule Changes By The Government Securities Clearing Corporation Regarding Its Proposed Netting System, Exchange Act Release No. 34-27,006, 54 Fed. Reg. 29,798 (July 14, 1989); NSCC 1989 Report, supra note 24, at 10.

50 Clearing banks normally obtain a security interest in all securities in a dealer-customer’s “clearing account”—i.e., securities not allocated to an account maintained with the clearing bank for fully paid-for securities of the dealer’s customers. See Stigum, Trade, supra note 4, at 177-79.
cover their overdrafts. Many of these transfers against payment involve so-called repurchase agreements (repos). 51

2. The Selection of Intermediaries by Market Participants

The propensity of investors to allow intermediaries to control their securities is apparent from the volume of DTC and NSCC custody and clearing activity. And, in the government securities market DI control is a necessity. Evidence of market behavior and anecdotal perceptions of professionals in the securities industry suggest that market participants 52 generally exercise extreme care in the selection of the intermediaries who are to control their securities. Given their awareness of potentially disastrous consequences of securities intermediary insolvency and misbehavior, to be addressed shortly, market participants tend to choose safe intermediaries where the risks of insolvency and misbehavior are perceived to be essentially nil.

The largest institutional investors, including insurance companies, pension funds, and investment companies (such as mutual funds) normally select large, “blue chip” commercial banks as their “custodians.” 53 Some other active investors, however, allow securities firms to control their securities. 54 The high level of success with which

51 Repos are an important means for dealers to obtain overnight financing necessary to maintain daylight overdrafts. See Stigum, The Repo And Reverse Markets 25-26, 57 (1989) (hereinafter, Stigum, Repo). In a repo, a seller of a security (a funds borrower) transfers the security to a buyer (a funds lender) under an arrangement whereby the securities seller agrees to repurchase the security on a specified date (often the next day) at a specified price, and the securities buyer agrees to resell the security back to the seller. From the perspective of the buyer, the transaction is a reverse repurchase agreement (reverse repo). Repos serve the function of secured borrowings and loans, although they are denominated as sales and resales. The economics of the transaction are such that when the seller (funds borrower) pays the repurchase price (i.e., repay the loan), the buyer (funds lender) receives a profit (a return on the money loaned). Id. at 3-5. The legal characterization of repos for various purposes is not clear. See infra note 122.

52 It should be emphasized again that this discussion does not encompass smaller investors who are fully covered by SIPC and private insurance. See supra note 8.

53 See Stigum, Trade, supra note 4, at 232 ("[M]ost major portfolio managers use a big (top 25) bank as a custody bank, and the general view is that the Fed is the de facto guarantor of any such bank."). Smaller institutional investors often use smaller custodians. Id. at 220-21. The use of custodian banks by institutional investors is not a recent phenomenon. See ABA Report, supra note 8, at 32. Legal restrictions on investment companies registered under the Investment Company Act of 1940 essentially make maintenance of their securities through an independent bank custodian the only practical alternative. See 15 U.S.C. § 80a-17(f) (1988); 17 C.F.R. § 270.17F-1-270.17F-4 (1990). Moreover, because institutional investors now use the DTC, ID System, the use of bank custodians that control securities through DTC essentially has been formalized. See supra note 15.

54 Knowledgeable sources within broker-dealers have provided some insight concerning investors that maintain customer accounts in excess of combined insurance coverage provided by SIPC and private insurance. One regional firm reported that as of a recent date only four (4) of its customer accounts exceeded in value its combined $10 million per customer SIPC and
large investors have selected securities intermediaries is indicated by the minimal losses experienced by investors not protected by SIPC when securities intermediaries have failed.\textsuperscript{55} The conclusion is inescapable that either intermediaries selected by important securities market participants generally have not failed or misbehaved to the investors’ detriment, or such failures have not resulted in serious shortfalls in customer securities. Significant losses incurred by claimants against several failed government securities dealers in recent years provide striking exceptions to this pattern.\textsuperscript{56} It also appears that many active investors tend to select only one custodian bank or securities firm to act as a principal securities intermediary.\textsuperscript{57}

B. Risks Posed by Securities Intermediaries

When an intermediary becomes insolvent and the securities that it controls are insufficient to satisfy all of the claims of its customers and creditors, priority disputes among claimants to the available securities may ensue.\textsuperscript{58} The applicable legal regime must sort out these

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\textsuperscript{55} During the period from 1971 through 1989, only 299 (less than .2\%) of the more than 250,000 claims made in SIPC proceedings exceeded the protection provided by SIPA. Securities Investor Protection Corporation, Annual Report 1989 (hereinafter SIPC 1989 Report). The aggregate unsatisfied portion of these claims through 1988 was $19.1 million. Id. Thus, the mean of unsatisfied portions of claims for these years was approximately $54,000. When compared to the size and volume of the securities markets, the relatively small mean losses indicate that the large, active investors generally have selected securities intermediaries that have not failed. Experience with failed commercial banks has been even more striking. Substantial shortfalls of customer securities controlled by failed banks have been virtually nonexistent. Telephone interviews with Carroll R. Shifflett, Assistant General Counsel, Federal Deposit Insurance Corporation (May 15 and June 29, 1989).
\textsuperscript{56} See infra notes 65-67 and accompanying text.
\textsuperscript{57} Telephone interview with Thomas F. Coolican, Assistant General Counsel, Metropolitan Life Insurance Company (July 6, 1989); Telephone Interview with Thomas L. Mahon, Jr., Assistant Treasurer, New York Life Insurance Company (June 28, 1989). The reason for this behavior doubtless arises from the fact that an active investor’s securities trades are, in effect, cleared and settled by its intermediary. See Sigum, Trade, supra note 4, at 219.
\textsuperscript{58} Part III, infra, considers how an inadequate ptc is divided when such events occur. The reasons why an intermediary might become insolvent, and the reasons why the securities available to an insolvent intermediary might be insufficient to satisfy the claims of its customers who have paid for the securities, are important areas of inquiry, but a detailed exploration of
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claims and distribute the assets of the insolvent firm (or the asset value) to some or all of the competing claimants. More significant, even when an intermediary has not failed, those who claim through insurance, those who employ that intermediary to execute trades, and secured creditors of and other transferees from that intermediary, all must consider, ex ante, what the effects of the intermediary failure would be. Although actual intermediary insolvencies and actual priority contests may be relatively rare, applicable distributional rules figure into an enormous variety and quantity of securities market transactions. These credit risks borne by customers and creditors of securities intermediaries are addressed and affected by a variety of approaches under existing federal and state law.

The regulatory approach makes it less likely that intermediaries will become insolvent. Financial institutions that serve as securities intermediaries, whether banks or securities firms, are subject to broad regulation and supervision. The regulatory approach also seeks to ensure that an intermediary will control sufficient securities to cover claims of its customers that have paid for them. Then, even if the intermediary were to become insolvent, customers' claims to securities would be satisfied. The "segregation" and other "customer protection" rules applicable to registered broker-dealers are examples.

those matters is beyond the scope of this article. Fraud, mistake, back office operational problems, and general market conditions may be involved.

59 Capital requirements, restrictions on powers, requirements of prudence, audits, financial reporting, and supervisory examinations are examples. See generally, e.g., Guttman, supra note 4, at 19-11 to -20 (reporting and net capital requirements for broker-dealers); A. Pollard, J. Passaic, K. Ellis & J. Daly, Banking Law in the United States 57-104 (1988) (bank regulators' enforcement powers), 191-266 (national bank powers and lending limits, restrictions on bank transactions with affiliates, reserve and capital requirements).

60 See infra Part III (discussing insolvency proceedings of securities intermediaries).

61 As a general matter, a broker-dealer is required to maintain possession or control of its customers' fully-paid and excess margin securities. See SEC Rule 15c3-3(b)(1), 17 C.F.R. § 240.15c3-3(b)(1) (1990) (broker or dealer must promptly obtain and maintain possession or control of fully-paid customer securities and customer excess margin securities); § 240.15c3-3(c) (specifying control of securities to include securities (i) deposited in a clearing corporation, (ii) in a broker's or dealer's account with another broker or dealer, (iii) in the process of transfer by an issuer or transfer agent, (iv) in the custody of certain foreign depositories, clearing agencies or custodian banks, (v) in the custody or control of a bank, (vi) in transit or in custody of a subsidiary of the broker-dealer, and (vii) in other control locations approved by the SEC) (in the case of locations mentioned in (ii) and (v), the securities must be maintained free of any charges, liens, or other claims of the other broker or dealer or the bank or persons claiming through any of them). This normally means that the customer securities are maintained in a "segregated" account maintained with the broker or dealer or bank. Broker-dealers are allowed some flexibility as to timing and, at any point in time, a broker-dealer that does not have possession or control of sufficient securities nevertheless may be in compliance. See, e.g., SEC Rule 15c3-3(b)(2), 15c3-3(d), 17 C.F.R. § 240.15c3-3(b)(2) (1990) ("temporary lags" in
Banks also are required to maintain possession or control of their customers’ securities. Not surprisingly, the regulatory approach is not foolproof, as both banks and securities firms sometimes fail and shortfalls in customer securities are the norm in securities firm insolvencies. Obtaining possession or control of securities are permitted if they result from “normal business operations” and the “broker or dealer takes timely steps in good faith to establish prompt physical possession or control”; § 15c3-3(d) (1990) (determination of possession or control of securities made at close of business day for next preceding business day and time periods specified for moving securities from certain noncontrol locations to qualifying control locations). Customers retain the “absolute right . . . to receive in the course of normal business operations following demand . . . the physical delivery of certificates.” SEC Rule 15c3-3(b)(1), 17 C.F.R. § 240.15c3-3(f) (1990). Broker-dealers also are required to maintain a special reserve account with a bank for the exclusive benefit of customers. SEC Rule 15c3-3(e), 17 C.F.R. § 240.15c3-3(e) (1990); see also 15 U.S.C. § 8(b) (1988); SEC Rule 8c-1, 17 C.F.R. § 240.8c-1 (1990) (broker-dealers prohibited from hypothecating customer securities so as to (i) commingle securities with other customer securities (in absence of customer’s consent), (ii) commingle customer securities with noncustomer securities, and (iii) secure amounts in excess of aggregate indebtedness of all customers to customer securities); SEC Rule 17a-13, 17 C.F.R. § 240.17a-13 (1990) (broker-dealers required to make quarterly counts and verifications of all securities they control and to compare the results with their records).

For example, national banks holding assets while acting in a fiduciary capacity in the exercise of trust powers must segregate those assets from the general assets of the bank. 12 U.S.C. § 92a (1988); see 12 C.F.R. §§ 9.1-9.22 (1990). When conducted by a national bank’s trust department, bank safekeeping and custody services are subject to the same rules that apply to fiduciary activities even though no investment discretion is involved. See Office of the Comptroller of the Currency, Handbook For National Trust Examiners, Precedents and Opinions, 5 Fed. Banking L. Rep. (CCH) ¶ 59,225, No. 9.2020 (1988). Although national banks that do not have trust powers may undertake safekeeping and custody arrangements that do not involve discretion, those activities are not subject to the same restrictions on control and segregation that apply in the case of trust departments. But all national banks that fail to exercise proper control over customer securities are subject to enforcement proceedings by the Comptroller of the Currency. See 12 U.S.C. § 92a(k) (1988) (proceeding to revoke trust powers on account of unlawful or unsound exercise of powers), § 1818(b) (1988) (proceeding for cease and desist order against national bank engaging in unsafe or unsound banking practices); see also Comptroller of the Currency, News Release No. 84-75 (November 21, 1984) (announcing consent order against First National Bank of Maryland relating to lending of customer securities kept in safekeeping).

From 1971, when SIPA was enacted, through 1989, 212 SIPA proceedings have been commenced. SIPC 1989 Report, supra note 55, at 6. Prior to SIPA, however, stockbroker insolvencies had been commonplace during some periods. See, e.g., id. at 32 (During the “difficult years of 1968-70 . . . hundreds of broker-dealers were merged, acquired or simply went out of business. Some were unable to meet their obligations to customers and went bankrupt. Public confidence in our securities markets was in jeopardy.”). In 1988, 200 banks insured by the FDIC failed. General Accounting Office, Financial Audit, Federal Deposit Insurance Corporation’s 1986 and 1987 Financial Statements 6 (1989). In 1987, 184 failed; in 1986, 138 failed; in 1985, 116 failed; in 1984, 78 failed; and in 1983, 48 failed. Federal Deposit Insurance Corporation, 1987 Annual Report 12 (1988). This article does not examine whether “improved” methods of regulation and supervision in the United States would result in substantially fewer insolvencies of financial institutions or whether any regulatory process having that result would be wise. Certainly that matter is receiving much attention, however. See, e.g., Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).
vencies. But the most serious shortfalls have occurred in cases of failed government securities dealers that were not subject to regulation. Largely as a result of these losses, the Government Securities Act of 1986 was passed. That Act requires the Secretary of the Treasury to adopt rules for customer protection, “including but not limited to, capital adequacy standards” and rules for “the acceptance of custody and use of customers’ securities.”

Experience with failed unregulated government securities dealers suggests that the regulatory approach may exert a more powerful influence than careful selection of intermediaries by investors. But these aberrations probably can be explained without undermining the basic assumption that market participants generally are successful in their selections of intermediaries.

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64 In the 206 proceedings commenced under SIPA through year-end 1988, all but eight required advances by SIPC to cover customer securities shortfalls. Telephone interview with J. H. Moelter, Vice President-Operations, Securities Investor Protection Corporation (October 18, 1989). Bank insolvencies, however, have resulted in a low incidence of shortfalls in customer property held in custody or trust. See supra note 55. It is possible that the differing experiences result, in part, from the fact that securities firms are more likely to be involved in active trading for their own accounts. Or, because bank custodians normally are selected to control securities for reasons of safety, it may be that banks with substantial custody accounts simply have not often failed.


67 15 U.S.C. § 78d-5(b)(1)(a) (1988). The Treasury regulations adopted under the Act require government securities brokers and dealers (including DIs not qualifying for exemption) that are not registered under the Securities and Exchange Act of 1934, as amended, to comply with SEC Rule 15c3-3, with certain exceptions. 17 C.F.R. § 403.1 (1990); see supra note 51 (discussing SEC Rule 15c3-3). Requirements similar to SEC Rule 15c3-1, dealing with net capital, also were adopted for those government securities brokers and dealers. See 17 C.F.R. § 402.2 - 402.2d (1990); SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1990).

68 See supra notes 52-57 and accompanying text (assumptions concerning market behavior). The biggest losers in these government securities dealer insolvencies were investors (such as school districts, municipalities, and thrift institutions) with cash to invest for short terms who entered into repo transactions. Many were victims of outright fraud who apparently believed (foolishly, perhaps, as it turned out) that their securities “collateral” was segregated and held for them by a third party custodian. For an enlightening treatment of one such dealer failure, see Failure of Bevill, Bresler & Schulman, A New Jersey Government Securities Dealer: Hearing Before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Senate Committee on Government Operations, 99th Cong., 1st Sess. (1985). Heightened sensitivity to intermediary risk, combined with regulatory controls, may prevent such huge losses in the future. Pursuant to regulations issued under the Government Securities Act, securities firms and banks who do not deliver repo “collateral” to their repo participants are
The insurance approach to customer risk is exemplified by the protection provided by SIPC, pursuant to SIPA, and private insurance covering customer interests. This approach provides protection to investors whose claims are within the coverage limits and who, by hypothesis, may lack the sophistication and resources necessary to evaluate any particular intermediary. These investors thereby may take advantage of the convenience of an intermediary account without substantial risk.

The property law approach—application of property law rules that protect purchasers against earlier and subsequent competing interests in the event of an intermediary insolvency—also may provide investor and creditor protection. Although these rules can provide security and comfort to a transferee of a property interest, reliance on traditional property law concepts for investor and secured creditor protection in the event of an intermediary insolvency is problematic. Existing property law rules either are not easily adaptable to the intermediary control-fungible bulk context or can result in little protection when applied. In many respects property law concepts provide an awkward and unsatisfactory approach to codifying rules for claims to securities controlled by intermediaries in fungible bulk. Moreover, property law rules ultimately must be applied in deference to distributional rules applicable in an insolvency proceeding, where they may or may not be honored.

A risk allocation approach contemplates legal rules that distribute assets to claimants based on objective classifications of the claimants' status and relationship to the failed firm. In contrast to the property law approach, a risk allocation approach would not be grounded on determinations of discrete property interests in particular assets. An example of this approach is the distributional rule applicable to securities firm insolvencies under SIPA."
The remainder of this article is largely devoted to the property law and risk allocation approaches, but the discussion necessarily proceeds in the constant shadow of the other approaches. It is not a criticism to note that the regulatory approach is not a panacea. Indeed, that approach, in tandem with the insurance approach, probably is the most important means of investor protection. But, even in the best of worlds, it is likely that intermediary insolvencies and shortfalls of securities will occur. And, especially, when failures and shortfalls are hypothesized ex ante, the system of allocating loss and resolving priority contests must be taken into account. Moreover, regulators must have some sense of the potential outcomes in order to determine what constitutes prudent behavior for regulated entities and how exposure can be minimized.

II. TRANSFER AND PLEDGE UNDER THE U.C.C. AND THE BOOK-ENTRY TREASURY REGULATIONS

This part introduces the implications of property law—primarily U.C.C. Articles 8 and 9 and, for book-entry Treasury securities, the Book-Entry Treasury Regulations—for intermediary risk. It addresses the creation and characteristics of the property interest (if any) received (in Example 1) by C-1, C-2, C-3, C-4, and I-1’s other customers—claimants on the same tier who share a common intermediary. It also addresses the creation and perfection of the security interests received by I-2 and L as secured lenders to I-1. The discussion exposes difficulties in applying the existing property law construct to fungible bulks of securities controlled by intermediaries. Be warned: the literature has not synthesized fungible bulk securities claims under current law. As a result, the descriptive component of the discussion can be tedious. Indeed, that is part of the story’s message.

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*line between the property law and risk allocation approaches is not clear. Under SIPA the assertion of or entitlement to a property claim may be necessary in order to determine that a claimant has “customer” status. Moreover, the application of property law rules to any priority contest necessarily has the result of allocating losses (and risk) to the subordinated parties. The differences lie, perhaps, only in the degree to which property law rules play a role in the risk allocation process.*

*75 Part IV contains a more detailed discussion of different-tier claims, such as the priority contests between C-1 and L, and C-1 and I-2. The distributional rules that operate in insolvency proceedings are considered in Part III.*
Chapter 1: Articles 8 and 9

1. Creation of Property Interest: Purchase, Transfer and Delivery

Section 8-313(1) specifies the exclusive means by which an interest in a security can be transferred to a purchaser and the time that a transfer occurs. Under the facts of Example 1, transfers to the customers of I-1 could have been effected only by confirmation and book entry (or other identification) under 1978 Section 8-313(1)(d)(iii). With one caveat, it seems a safe assumption that, in Example 1, transfers of property interests were effected.

The pre-1978 Article 8 does not address the means by which a property interest in securities is transferred to purchasers, such as I-1's customers, who acquire interests through an intermediary, such as I-1, when the intermediary controls securities in a fungible bulk. Instead, pre-1978 Section 8-313(1) specifies the necessary elements, and time of effectiveness, of a delivery. Transfers such as those

76 U.C.C. § 8-313, marked to reflect additions and deletions from the pre-1978 version, is quoted in full in Appendix I to this article. A brief drafting history of § 8-313 is set forth in Appendix II to this article. Readers who have a particular interest in the details of how to read § 8-313 may find it useful to read Appendix II at this point.

77 See id. § 1-201(32) (defining “purchase” to include “taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property”); § 1-201(33) (defining “purchaser” as “a person who takes by purchase”).

78 U.C.C. § 8-313(1). “The word ‘only’ in the first sentence is intended to provide that the methods of transfer listed are exclusive and that compliance with one of them is essential to a valid transfer.” Id., comment 1.

79 Id. § 8-313(1)(d)(iii) (transfer occurs “at the time a financial intermediary” [here, I-1] sends a confirmation to the purchaser “and also by book entry or otherwise identifies as belonging to the purchaser . . . a quantity of securities that constitute or are part of a fungible bulk of securities shown on the account of the financial intermediary [I-1] on the books of another financial intermediary [here, I-2]”); see also id. § 8-313(1)(d)(ii) (transfer, by confirmation and book entry, of interest in fungible bulk of certificated securities in financial intermediary’s possession or uncertificated securities registered in name of financial intermediary).

80 See infra notes 92-95 and accompanying text (discussing effect of absence or insufficiency of securities controlled by intermediary at time of putative transfer).

81 The “fungible bulk” concept is discussed in more detail infra notes 92-95 and accompanying text.

82 Pre-1978 § 8-313(1); see U.C.C. § 1-201(14) (“‘Delivery’ with respect to . . . certificated securities means voluntary transfer of possession.”). Pre-1978 § 1-201(14) does not include the word “certificated.” Moving from a delivery-based to a transfer-based structure also facilitated another important feature of the 1978 Article 8—the treatment of uncertificated securities in a fashion that is largely parallel to the treatment afforded certificated securities. See U.C.C. § 8-102(1)(b) (defining “uncertificated security,” in part, as “a share, participation, or other interest in property or an enterprise of the issuer or an obligation of the issuer which is (i) not represented by an instrument and the transfer of which is registered upon books maintained for that purpose by or on behalf of the issuer”). Uncertificated securities may be transferred by registration of the transfer on the books of the issuer. Id. § 8-313(1)(b). Registration of transfer is initiated by the sending of an “instruction” by an “appropriate person” (the current registered owner if the security is not subject to registered pledge) to the issuer. Id.
made to I-1's customers, mainstays of the stockbrokerage business for many years, do not constitute deliveries under pre-1978 section 8-313(1), but it is clear that a property interest can be transferred nonetheless under the common law.83

The principal operative rule in the 1978 Article 8 that deals with the purchase of securities is found in section 8-301(1): “Upon transfer of a security to a purchaser (Section 8-313), the purchaser acquires the rights in the security which his transferor had or had actual authority to convey . . . .” Pre-1978 section 8-301(1) is to the same effect except it states the effect of a delivery of a security rather than the effect of a transfer.84 It follows that under the pre-1978 section 8-301(1) a delivery is a sufficient condition for transfer of an interest in a security to a purchaser, but a delivery is not a necessary condition for such a transfer of a property interest to occur.85 But even this basic point has sometimes been missed.86 Both versions of section 8-301(1) state the familiar “shelter principle”—a purchaser receives what its transferor had—and by implication the common law maxim nemo dat quod non habet—one cannot give what one does not have.87

§ 8-308. For a description of the process of registration of transfer, see Reporter’s Comment, supra note 5, at 936; Guttman, supra note 4, at 5-9 to 5-14.

83 See infra notes 97-100 and accompanying text (discussing operation of “proportionate property interest” rule of § 8-313(2) (second sentence)); Appendix II, infra, notes 12-14. Because U.C.C. § 8-313(1) specifies the exclusive means of transfer, provisions were added that accommodate expressly these nondelivery transfers effected by confirmation and book entry. See U.C.C. § 8-313(1)(d)(ii), (d)(iii). In addition, references to a “broker” (defined in both versions of § 8-301) in pre-1978 § 8-313 were changed to the broader category of “financial intermediary” (defined in U.C.C. § 8-313(4) to include banks, clearing corporations, and other appropriate entities in addition to brokers).

84 U.C.C. § 8-301(1). U.C.C. § 8-301(2) provides important gloss: “A transferee of a limited interest acquires rights only to the extent of the interest transferred. The creation or release of a security interest in a security is the transfer of a limited interest. . . .”

85 Pre-1978 § 8-301(1).

86 Id.; see supra note 83.

87 See, e.g., Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. 557, 603, 615 (D.N.J. 1986) (“Under [pre-1978] Article 8 . . . , the transfer of ownership of securities to a purchaser is governed by the concept of ‘delivery.’ . . . [I]f the three requirements for achieving delivery/transfer under . . . [pre-1978 § 8-313(1)(c) or U.C.C. § 8-313(1)(d)(i)] are not satisfied, then a purchaser acquires no interest in the securities.”); Memorandum of Law of the Federal Reserve Bank of New York as Amicus Curiae, County of Dauphin v. Bradford Trust Co., No. 85 Civ. 2220 (S.D.N.Y. 1985) [hereinafter Bradford Trust Memo], reprinted in Ringsmuth, Federal Reserve Book-Entry System, and the Role of the Federal Reserve, in Repurchase and Reverse Repurchase Agreements 110-11 (PLI 1985) (A. Levin and H. Novikoff, co-chairmen) (“If the delivery did not meet the requirements of N.Y. [pre-1978] U.C.C. § 8-313(1)(c), it appears that the purchaser did not acquire any rights in the security. Thus, if the broker became insolvent, the purchaser could not enforce a claim to the securities against the broker’s estate.”).

88 See U.C.C. § 8-301 comment 1; pre-1978 § 8-301 comment 3. Because pre-1978 section 8-301(1) deals only with delivery, it does not speak directly to the applicability of “shelter” or nemo dat in the context of non-delivery transfers such as those made to I-1’s customers.
2. Priorities and Sharing on the Same Tier: First-in-Time, Bona Fide Purchase, and Proportionate Property Interest

The conclusion that I-1’s customers are purchasers who have received transfers of property interests in securities does not, alone, suggest a resolution of the priority contests raised by Example 1—such as the contest between C-2 and C-3, each of whom has a claim to a quantity of C Co. securities (controlled by I-1) that is insufficient to satisfy both claims. Application of the nemo dat principle to the C-2 and C-3 claims, however, would result in priority for the customer who received its transfer first-in-time.89

Both versions of Article 8 contain the familiar exception to the baseline rule of nemo dat: “A bona fide purchaser in addition to acquiring the rights of a purchaser (Section 8-301) also acquires his interest in the security free of any adverse claim.”90 But only certain transferees can achieve bona fide purchaser status.91 In particular, transferees (such as I-1’s customers) of an interest in a fungible bulk of securities through an intermediary (such as I-1) cannot become bona fide purchasers.92 Although that general statement may not be

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89 If C-2’s interest arose first and nemo dat were applied, I-1 could not later transfer to C-3 an interest in the C Co. securities that had already been transferred to C-2.

90 U.C.C. § 8-302(3); see, e.g., Satterfield v. Haymond, No. C-84-0646W (D. Utah Oct. 31, 1985) (LEXIS, Genfed library, Dist file); Matthysse v. Securities Processing Servs., Inc., 444 F. Supp. 1009, 1020-23 (S.D.N.Y. 1977). Pre-1978 § 8-301(2) is to the same effect. “Adverse claim” is defined identically in U.C.C. § 8-302(2) and pre-·1978 § 8-301(1) to include “a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security.” As to what constitutes notice of an adverse claim, see U.C.C. § 8-304; Matthysse, at 1020-23; Satterfield No. C-84-0646W (D.Utah).

91 U.C.C. § 8-302(1) provides:

(1) A “bona fide purchaser” is a purchaser for value in good faith and without notice of any adverse claim:

(a) who takes delivery of a certificated security in bearer form or in registered form, issued or indorsed to him or in blank;

(b) to whom the transfer, pledge or release of an uncertificated security is registered on the books of the issuer; or

(c) to whom a security is transferred under the provisions of paragraph (e), (d)(i), or (g) of Section 8-313(1).

Pre-1978 § 8-302(1) was substantially the same as U.C.C. § 8-302(1)(a). Subparagraph (1)(b) was added in the 1978 official text so as to accommodate uncertificated securities and subparagraph (1)(c) was added for clarity only, the same result following from both versions of § 8-313(2) (first sentence). See U.C.C., app. 1, § 8-302, Reasons for 1977 Change, at 964 (1989).

92 See U.C.C. §§ 8-302(1)(c), 8-313(1)(d)(ii)-(iii), 8-313(2) (first sentence), pre-1978 § 8-313(2); infra notes 218-232 and accompanying text (rebuiting arguments and authorities to the contrary). The Official Comment to U.C.C. § 8-313 explains:

If bona fide purchaser status were given to those whose securities are held as part of a fungible bulk, there would be a possibility of inconsistent claims between two or more bona fide purchasers, since if the bulk should prove to be smaller than was expected, the claim of one or both must be compromised.

Id. § 8-313 comment 4; see also Haydock, When Is a Broker a Bailee or is an Interest in
controversial, the circumstances that remove securities from a fungible bulk by specific identification have proven to be highly controversial and often misunderstood. 93 When the intermediary involved is a clearing corporation 94 (such as DTC), book entry transferees of interests in fungible bulks on the clearing corporation's books can achieve bona fide purchaser status. 95

Because I-1's customers could not have become bona fide purchasers, it would seem to follow from the foregoing that the priority contest between C-2 and C-3 would be resolved on the basis of first-in-time. 96 But Article 8 provides a different answer: The purchaser of an interest in a fungible bulk of securities pursuant to 1978 section 8-313(1)(d)(ii) or (iii) "is the owner of a proportionate property interest in the fungible bulk." 97 The same result obtains under the pre-1978 Article 8. 98 This means that all purchasers claiming an interest in a

Securities a General Intangible?, 35 Ark. L. Rev. 10, 18 (1981) (U.C.C. § 8-313(2) "makes sense, since it avoids giving one bona fide purchaser priority over another"). This reasoning misses the mark. There is nothing odd about the transfer of securities to a series of bona fide purchasers; the last-in-time would cut off the rights of earlier purchasers. See Guttman, supra note 4, at 8-4 n.17. What the comment and Haydock probably intended to recognize is that such transfers of interests in fungible bulks do not fit the paradigm of delivery of a discrete negotiable instrument and the corresponding policy that transferees who share a common intermediary ought to share according to the "proportionate property interest" rule. See infra text accompanying notes 97-100.

93 See infra notes 218-232 and accompanying text (discussing requisites of identification of a specific security within the meaning of U.C.C. § 8-313(1)(d)(i) and pre-1978 § 8-313(1)(e)).
94 See U.C.C. § 8-102(3) (defining "clearing corporation").
95 Id. §§ 8-302(1), 8-313(1)(g), (2) (first sentence), 8-320; pre-1978 §§ 8-313(2) (first sentence), 8-320; see Satterfield v. Haymond, No. C-84-0646W (D.Utah Oct. 31, 1985) (LEXIS, Genfed library, Dist. file); supra notes 23-38 and accompanying text (discussing role of DTC and NSCC); infra notes 339-44 and accompanying text (discussing rationale for bona fide purchaser status of clearing corporation transferee). U.C.C., § 8-313(1)(g) refers to "entries to the account of the purchaser or a person designated by him" (the italicized words having been added to the pre-1978 paragraph (1)(e)). Read literally, the "designated by him" language would seem to say that a purchaser who is a customer of an intermediary-participant in a clearing corporation can receive a transfer under paragraph (1)(g) and, thereby, become a bona fide purchaser. The "designated by him" reference apparently was derived from paragraph (1)(a) (where it appears in both the 1978 and pre-1978 versions merely to incorporate a general agency principle), perhaps in the (misguided) interest of consistency. That literal reading of paragraph (1)(g) would mean that many routine transfers of interests in fungible bulks in the securities markets become bona fide purchasers—certainly not the intended result under paragraph (1)(g). See Kalzman, Security Interests in Federal Agency Book-Entry Securities: Dealing It With Mirrors, 42 Bus. Law. 157, 176 (1986) (transfer on books of clearing corporation can become bona fide purchaser, but transferee's customer cannot; the "designated by him" language was not discussed); supra note 92.
96 See supra note 92 and accompanying text.
97 U.C.C. § 8-313(2) (second sentence).
98 Pre-1978 § 8-313(2) (second sentence) is to the same effect as the 1978 version. Although pre-1978 Article 8 contained no express provisions dealing with how such transfers are effected, transfer of a proportionate property interest in a fungible bulk to I-1's customers
fungible bulk of a particular issue of securities controlled by I-1 have a proportionate property interest shared ratably with all other transferees of that issue. Applying this formulation to the C Co. securities in Example 1, C-2 and C-3 would share the available C Co. securities proportionately according to the number of units to which each is entitled.

If the facts of Example 1 are varied slightly, application of the proportionate property interest formulation becomes much more difficult. Assume that only a portion of the C Co. securities controlled by I-1 is in I-1’s account with I-2, another portion is in I-1’s account with another intermediary (I-2A), and yet another portion comprises a fungible bulk of street name securities in I-1’s physical possession. Will the treatment of the claims of C-2 and C-3 now depend on which one or more of these three fungible bulks have been identified by I-1 as subject to their respective claims and the quantity of C Co. securities in each relevant fungible bulk? If so, and if I-1 has failed to identify any particular fungible bulk to the claims of C-2 and C-3, is the result that no transfer to C-2 or C-3 has occurred? The property construct embodied in the language of section 8-313(1)(d)(ii) and (iii) and 8-313(2) would seem to suggest an affirmative answer to each of these questions. But the answer to each question ordinarily ought to be

would occur outside of Article 8 as a matter of contract and common law. See Appendix II, infra, notes 12-14 and accompanying text.

99 See U.C.C. § 1-301(17) (“‘Fungible’ with respect to . . . securities means . . . securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit.”); see also id. § 8-107(1) (“[A] person obligated to transfer securities may transfer any certificated security of the specified issue . . . or . . . an equivalent uncertificated security . . . .”) (emphasis added). The second sentence of § 8-313(2) has rarely been interpreted by the courts. However, one court may have applied the sharing principle as among all customers with respect to all types of securities controlled by the intermediary, although the facts are not clearly reflected by the reported opinion. United States v. Doyle, 486 F. Supp. 1214 (D. Minn. 1980).

100 Under this analysis, C-4 (the only claimant to a sufficient quantity of D Co. securities) would be fully satisfied. Whether C-1’s claims to A Co. and B Co. securities would be satisfied depends on the resolution of the different-tier priority contests with I-2 and L, discussed infra Part IV. It has been suggested, incorrectly in my view, that the proportionate property interest rule applies as among claimants on different tiers. See infra notes 243-46 and accompanying text (arguing that the proportionate property interest rule is inapplicable except as among claimants that share a common intermediary). It also has been suggested that the purpose of the proportionate property interest rule is to provide a distributive rule to be applied in cases of intermediary insolvency, but that suggestion is questionable as well. See infra notes 182-86 and accompanying text. To the extent otherwise applicable, state property law is controlling in an intermediary’s insolvency proceeding. It is true, however, that the rule would serve that function in fact. See infra note 200 and accompanying text.

101 A transfer pursuant to either U.C.C. § 8-313(1)(d)(ii) or § 8-313(1)(d)(iii) requires that “a financial intermediary . . . identify[y] as belonging to the purchaser . . . a quantity of securities that constitute or are part of a fungible bulk . . . .” U.C.C. § 8-313(1)(d), (d)(ii) (emphasis added). The proportionate property interest rule of § 8-313(2) applies to securities that are “part of a fungible bulk.” Id. § 8-313(2) (emphasis added).
"no," although no authorities appear to have addressed these issues squarely. In practice, securities firms do not identify the claims of customers, who have paid for securities, to any particular fungible bulk. Following the interpretation that is consistent with practice—that the "fungible bulk," for these purposes, is comprised of all of the securities of a given issue that are controlled by I-1 and identified as belonging to customers who have paid for them—seems appropriate. Where a different practice prevails, however, it is arguable that a different result would be fitting.

In sum, transfers of interests in a fungible bulk of securities made pursuant to an intermediary's confirmation and book entry subject the transferee's interest to the proportional property interest rule. The proportionate property interest formulation is the baseline rule provided by Article 8 concerning the priorities among claimants to securities controlled by a common intermediary, i.e., claimants on the same tier.

3. Transfer of Nonexistent or Insufficient Quantity of Securities

The foregoing discussion implicitly assumed that at the time I-1 originally effected transfers to C-2 and C-3 there were sufficient C Co. securities controlled by I-1 so as to satisfy both claims. Now assume that I-1 took all steps necessary to effect transfers to C-2 and C-3 except that at the relevant times I-1 itself did not control any C Co. securities. Under Article 8, it is likely that no effective transfer occurred. That result is not surprising, given the traditional property law concept of nemo dat.

Next, assume that, at the time of the transfer to C-2, I-1 controlled sufficient C Co. securities to cover C-2's claim, but at the subsequent time of the putative transfer to C-3, I-1 controlled a quantity that was insufficient to satisfy both claims. The shortfall of C Co. securities might have resulted from mistake, an unexpected development, or even fraud. In that situation, it is theoretically possible

102 Interview with Jonathan Kallman, SEC Division of Market Regulation (June 23, 1989). Nor are securities firms required to do so. See supra note 61.
103 For example, banks normally maintain records reflecting a fungible bulk of securities for trust department customers that is separate from fungible bulk maintained for other customers.
104 U.C.C. § 8-313(1)(d)(ii) and (d)(iii) refer to the transfer of "a quantity of securities that constitute or are part of a fungible bulk" of securities that are in the intermediary's possession, or (if uncertificated) registered in its name, or shown on its account with another intermediary. U.C.C. § 8-313(1)(d)(ii), (d)(iii).
105 I-1 might not have received the C Co. securities to be transferred as a result of a failed trade. Or, I-1 might have become insolvent after the putative transferee's payment to I-1 but
that a transfer to C-3 would occur, resulting in application of the proportionate property interest formulation as between C-2 and C-3. Yet, it also is possible that C-3 would not receive a transfer of any property interest whatsoever under Article 8.

While far from shocking under a property law construct, the treatment of a putative transferee, such as C-3, as an unsecured creditor, intuitively seems questionable. C-2, a preexisting customer, and C-3 have common interests, have behaved similarly, have taken the same risks, and are victims of the failure of I-1, their common intermediary. Moreover, the fact that C-2 and C-3 are both victims of a shortfall and C-4 is made whole is largely fortuitous. As a practical matter, none of I-1's customers would be able to ascertain, either at the time of a putative transfer or thereafter, that I-1 actually controlled a fungible bulk sufficient to satisfy their claims. I-1's customers would be able to ascertain, either at the time of a putative transfer or thereafter, that I-1 actually controlled a fungible bulk sufficient to satisfy their claims.

106 To reach this result it would be necessary to find some book entries or other actions by I-1 that would satisfy the identification requirement. See U.C.C. § 8-313(1)(d)(ii)-(iii).

107 A court might refuse to award C-3, the putative transferee, with a property right in securities already on hand, to the detriment of C-2, if it appeared that I-1 did not intend to dilute C-2's interest by identifying C-3's putative interest to the same fungible bulk. However, that approach could yield bizarre results. The entire transfer to C-3 could be nullified even though the C Co. securities on hand were only one unit short. A similar result (i.e., no transfer) could occur even if I-1 subsequently acquired securities in order to cover the shortfall, since U.C.C. § 8-313(d) does not expressly contemplate the intermediary's acquisition of the securities after the other steps necessary for transfer have occurred. But a reasonable reading should accommodate the conclusion that a transfer would occur. Cf. Aronstein, Haydock & Scott, supra note 5, at 911-912 (arguing that the “at the time” language of U.C.C. § 8-313(1) should not be read to preclude subsequent satisfaction of additional requirements of U.C.C. § 8-321 for attachment and perfection of a security interest). Moreover, the customer protection rules applicable to registered broker-dealers expressly contemplate that compliance is not inconsistent with temporary shortfalls in customer securities. See supra note 61.

108 Stated otherwise, in the event of an intermediary insolvency, perhaps putative transferees who have paid cash to the intermediary should be treated the same as customers who have actually received transfers of securities. Presumably, the putative transferee would have paid for the securities and would be entitled, at a minimum, to a claim for the money paid or a damage claim. If no payment had been made, then the “no transfer” result would not be so harsh.

109 The argument that C-2 and C-3 should receive similar treatment is developed below in the discussion of risk sharing distributional rules applicable to customers in intermediary insolvency proceedings. See generally infra Part III.

110 If a transferee of an interest in a fungible bulk of securities looks to the books of its intermediary for evidence of a transfer, those books normally would show interests of many other transferees of interests in the same fungible bulk. Only a continuing “audit” of the books of the intermediary and the securities in the intermediary’s possession and those credited to its account with other intermediaries would provide assurance that the fungible bulk contains sufficient securities to cover the interests of all of the intermediary’s customers. This would involve a determination of the aggregate claims against the fungible bulk as well as the aggregate volume of securities included in the fungible bulk. When the fungible bulk includes securities in accounts of the transferee’s intermediary with other intermediaries, the same analysis of
tomers must rely on both the ultimate financial strength and integrity of their intermediary and regulatory controls designed to prevent or discourage such shortfalls.

4. Transfer of Security Interests (Pledges)

The preceding discussion assumed that I-1’s customers were purchasers of ownership interests in securities. The exclusive methods of transfer specified in section 8-313(1) also apply to the “[t]ransfer of a limited interest (including a security interest)” in a security. If the transfer is made “[p]ursuant to agreement by a transferor who has rights in the security to a transferee who has given value, [it] is a perfected security interest.” Although a security interest can be transferred pursuant to any subparagraph of section 8-313(1), certain subparagraphs of section 8-313(1) specify the time of transfer only for security interests. Returning to Example 1, L presumably was a

the aggregate volume and aggregate claims would be required as to the other intermediaries. Such investigations are not compatible with most securities transactions. The status of the various accounts would be constantly changing in any event. See Aronstein, Haydock & Scott, supra note 5, at 910, n.101:

As a practical matter, one who purchases through . . . an intermediary does not investigate any further. He assumes that the intermediary holds a valid and unencumbered interest and relies on the intermediary’s integrity and financial strength. The kind of inquiry . . . which goes behind the intermediary’s confirmation, would rarely, if ever, be undertaken.

James Rogers is critical of tracing rules generally.

The commingled fund tracing rules are perhaps the most elaborate and detailed attempt anywhere in our legal system to retain the normative consequences of mine versus thine even though the objects of these property concepts have irretrievably lost their identifiable thingness. As we have seen, the results are not impressive.

Rogers, Negotiability, supra note 15, at 301.

111 U.C.C. § 8-313(1); see id. § 8-301(2) (quoted supra note 84). A security interest in a security is enforceable only if it has been transferred to the secured party (or its designee) pursuant to U.C.C. § 8-313(1). U.C.C. § 8-321(1); FDIC v. W. Hugh Meyer & Assoc., Inc., 864 F.2d 371, 374 (5th Cir. 1989); In re Domestic Fuel Corp., 70 Bankr. 455, 460 (Bankr. S.D.N.Y. 1987). Consistent with commonly used securities industry parlance, “security interest” and “pledge” are used interchangeably in this article, whether or not the security interest is a possessory one. See U.C.C. § 1-108 (registration of pledge of uncertificated security); id., app. 1, § 1-108, Reasons for 1977 Change, at 953 (“pledge . . . reflects common terminology”).

112 Id. § 8-321(2). The filing of an Article 9 financing statement is not required. Id. § 8-321(3)(a); In re Domestic Fuel Corp., 70 Bankr. at 464.

113 U.C.C. § 8-313(1)(n) (time of written notice, after debtor has signed a security agreement describing collateral, given to debtor’s financial intermediary or third party in possession of, or who is registered owner or pledgee of, security); (1)(i) (if debtor has signed a written security agreement describing the collateral, time that new value is given by secured party); (1)(j) (if secured party is financial intermediary to whom security has already been transferred, time debtor signs security agreement describing collateral and secured party gives value). Transfer pursuant to U.C.C. § 8-313(1)(i) provides only temporary perfection that is essentially equivalent to pre-1978 § 9-304(4). U.C.C. § 8-321(2) (“[s]ecurity interest . . . transferred
transference of its perfected security interest pursuant to section 8-313(1)(d)(iii) by virtue of both confirmation and book entry made by I-2 upon I-1’s instructions.\(^\text{114}\) I-2, on the other hand, received a transfer and a perfected security interest when it gave value and I-1 signed a security agreement describing the collateral, pursuant to section 8-313(1)(j).\(^\text{115}\)

The treatment of all aspects of creation and perfection of security interests in the 1978 Article 8 and the corresponding removal of those matters from Article 9 have been strongly criticized.\(^\text{116}\) The resulting unification within 1978 Article 8, however, has produced some distinct improvements. The confusion as to whether provisions of Article 8 or Article 9 control the perfection of security interests in securities has been removed.\(^\text{117}\) Other changes in substance also have

solely under paragraph (i) of Section 8-313(1) becomes unperfected after 21 days unless, within that time, the requirements for transfer under any other provision of Section 8-313(1) are satisfied."); see also U.C.C. §§ 8-108, 8-313(1)(b), 8-321 (perfection of security interest in uncertificated security by registration of pledge); Reporter’s Comment, supra note 5, at 936-37 (discussing registration of pledge); Guttman, supra note 4, at 5-56 to 5-57 (discussing registration of pledge); supra note 82 (discussing registration of transfer).

\(^\text{114}\) See U.C.C. § 8-313(1)(d)(iii).

\(^\text{115}\) See id. § 8-313(1)(j); supra note 113.

\(^\text{116}\) See Coogan, supra note 5, at 1052-69; Rasor, A Critical Look at Secured Transactions Under Revised Article 8, 14 Fla. St. L. Rev. 859, 868-72 (1987). Both authors appear to have been substantially influenced by nostalgic concerns about abandoning Article 9's generally successful approach of dealing with security interests in personal property in one place. See Coogan, supra note 5, at 1052-53; Rasor, supra, at 868-69. Aronstein, Haydock and Scott responded to Coogan's article by explaining persuasively that many of Coogan's problems with the 1978 Article 8 also exist under the pre-1978 versions of Articles 8 and 9 and that others are not serious. See Aronstein, Haydock & Scott, supra note 5, passim. For discussions and comparisons of secured transactions covering securities under the pre-1978 Articles 8 and 9 and the 1978 Article 8, see Aronstein, Security Interests in Securities: How Code Revision Reflects Modern Security-Holding Practices, 10 U.C.C. L.J. 289 (1978) [hereinafter Security Interests] and Haydock, supra note 92.

\(^\text{117}\) For example, when a third party bailee is in possession of securities collateral, under pre-1978 § 9-305 a secured party can achieve perfection “from the time the bailee receives notification of the secured party’s interest.” Pre-1978 § 9-305 (second sentence). But pre-1978 § 8-313(1)(d) can be construed to mandate that the perfection requires an acknowledgment by the third party bailee. See Security Interests, supra note 116, at 296 (“It is surely not a strained construction to conclude that the creation of a security interest in a security is the ‘purchase of a limited interest’ therein, and, therefore, governed by the provisions of [pre-1978] Part 3 of Article 8.”); Haydock, supra note 92, at 15-16; see also Winnett v. Invernness Counsel, Inc., No. 77 C.V. 3810 (S.D.N.Y. Aug. 14, 1979) (holding that third party bailee must agree to hold for notifying secured party and mere notice is insufficient for perfection, but not citing pre-1973 § 8-313(1)(d)), aff’d, 614 F.2d 1293 (2d Cir. 1979). Commentators generally take the view, however, that pre-1973 § 9-305 ought to control over any contrary provision of 1973 Article 8 unless an Article 8 transfer is a subsequent bona fide purchaser. See U.C.C. 9-309; pre-1973 § 9-309; Guttman, supra note 4, at 5-55; Haydock, supra note 92, at 16-17; see also Hale v. Kontaratos (in re Kontaratos), 10 Bankr. 936, 970 (Bankr. D. Me. 1981) (when third person in possession is senior secured party, notice under pre-1973 § 9-305 must come from the debtor); Note, Notice Problems in the Double-Pledge Situation, 55 Fordham L. Rev. 609,
made perfection less cumbersome. For example, under the pre-1978 Articles 8 and 9, L’s security interest could not be perfected merely by the transfer of A’s Co. securities to L’s account on I-2’s books.

Arguably, section 8-313(1)(d) provides a means for perfecting a security interest even when the intermediary that effects the transfer by book entry and confirmation is, itself, the debtor. Under this

817-37 (1987) (disagreeing with result and analysis in Konaratos, but not questioning the applicability of pre-1978 § 9-305 perfection by notification of security interests in securities). When securities are controlled by intermediaries in fungible bulk, U.C.C. § 8-313(1)(h) makes it clear that transfer (and perfection) can be achieved by the debtor’s notice to the debtor’s intermediary. U.C.C. § 8-313(1)(h).

118 Because I-3, not I-2, is in possession of the A Co. securities, I-2 is not the proper party to receive notification under pre-1978 § 9-305 or to make an acknowledgment pursuant to pre-1978 § 8-313(1)(d). L would be forced to deal with I-3, or to insist on a physical delivery to either I-2 or L, in order to achieve perfection. Arguably, I-2’s security interest is perfected under the pre-1978 versions. Because I-3 holds the B Co. securities on behalf of I-2, its customer, I-3’s awareness of I-2’s interest would seem to satisfy the notice requirement of pre-1978 § 9-305, even though I-3 does not know about I-1’s interest on the books of I-2.

119 U.C.C. § 8-321(1) - (2) makes it clear that (subject to the requirements of agreement, debtor’s rights in the collateral, and value) transfer of a security interest in a security under any paragraph of section 8-313(1) is sufficient for the attachment and perfection of a security interest. See U.C.C. § 8-301(2) (quoted supra note 84); supra notes 111-13 and accompanying text. U.C.C. § 8-313(1)(d) makes no distinction between transfers of entire interests (ownership) and limited interests (such as security interests), unless that distinction can be read into the phrase “identifies as belonging to the purchaser.” U.C.C. § 8-313(1)(d) (emphasis added).

A financial intermediary who is a debtor-transferor, then, would act in two capacities—as debtor-transferor of a security interest and as the secured party-transferee’s financial intermediary. Cf. U.C.C. § 8-313 comment 2 (broker can be a “financial intermediary” and also act in, capacity of pledgee from customer). This conclusion, however, is not free of doubt. First, a “financial intermediary” is defined as a “[p]erson . . . who maintains security accounts for its customers and is acting in that capacity.” U.C.C. § 8-313(4) (emphasis added). It is not clear that the intermediary’s secured creditor would be a “customer” for this purpose. Second, it is a longstanding tenet of the common law that a debtor cannot serve as an agent or bailee of a secured party for purposes of delivery and possession of collateral so as to create and perfect a pledge. See 1 G. Gilmore, Security Interests In Personal Property § 14.2 (1965). This principle has been left intact by the U.C.C. See U.C.C. § 9-305, comment 2 (“[i]t is of course clear, however, that the debtor or a person controlled by him cannot qualify as . . . an agent for the secured party.”); Starr v. Bruce Farley Corp. (In re Bruce Farley Corp.), 612 F.2d 1197, 1200 (9th Cir. 1980) (“The debtor cannot qualify as an agent for the secured party for the purpose of perfection.”); Huffman v. Wikle (In re Staff Mortgage & Inv. Corp.), 550 F.2d 1228, 1230 (9th Cir. 1977) (U.C.C. drafters did not intend that debtor could be agent for purposes of perfection and possession); see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Van Kylen (In re Van Kylen), 98 Bankr. 455, 460-461 (Bankr. W.D. Wis. 1989) (where a debtor retained investment discretion and the right to withdraw securities from its account with a securities firm intermediary, the intermediary was not an agent of the secured party “designated by him” within the meaning of U.C.C. § 8-313(1)(a), and notice to the intermediary of the security interest was ineffective to effect a transfer and perfect a security interest, but the court failed to consider U.C.C. § 8-313(1)(h)(i), pursuant to which a transfer by notice given to a debtor’s financial intermediary can be effective to perfect a security interest); FDIC v. Mount Pleasant Professional Sldg. (In re Mt. Pleasant Bank & Trust Co.), 426 N.W.2d 126, 132-133 (Iowa 1988) (notification to debtor’s intermediary (a bank) of security interest in securities controlled by that intermediary was sufficient to perfect a security interest under pre-1978 § 9-305).
analysis, if C-3 (in Example 1) were a secured lender to I-1, (rather than an ownership claimant), the foregoing discussion of transfer and priorities between C-2 and C-3 would remain applicable and the proportionate property interest formulation would apply as between these two claimants.\textsuperscript{120} Recognition of such a transfer could provide some comfort to a secured creditor or a repo transferee\textsuperscript{121} because the transfer would be both effective and perfected regardless of whether it was characterized as an outright sale or a secured transaction.\textsuperscript{122}

\textsuperscript{120} U.C.C. § 8-313(2) (second sentence) continues to refer to the “ownership” of a purchaser. But, given the goal of unifying both security interest and nonsecurity interest transfers in U.C.C. § 8-313(1), the second sentence of subsection (2) could be read to apply also to same-tier security interests and ownership interests alike (e.g., where the debtor is itself the intermediary effecting a transfer, or where a secured party transferee gives a notice, under U.C.C. § 8-313(1)(b)(i), to an intermediary whose customer is the debtor). See supra notes 110-113. It could be argued, however, that the priorities should be determined according to the time of perfection. See U.C.C. § 8-321(3) (with certain exceptions, a “security interest in a security is subject to Article 9”); § 9-312(5)(a) (priority for first to perfect when perfection is not by filing). That approach could involve difficult tracing problems and would seem to be wholly at odds with the proportionate property interest concept. See supra notes 97-100 and accompanying text.

\textsuperscript{121} See supra note 51 and accompanying text. Many lenders to securities firms extend secured credit without taking delivery of the collateral—so-called “A-P” (“agreement to pledge”) loans—while relying on “temporary perfection.” See U.C.C. §§ 8-313(1)(i), 8-321(2) (21-day temporary perfection); pre-1978 § 8-304(4) (same); Interview with James Clark, Vice President, Citibank, N.A. (June 22, 1989). Unless specific securities in the debtor’s possession have been identified within the meaning of U.C.C. § 8-313(1)(d)(i) or pre-1978 § 8-313(1)(c), such a secured lender cannot achieve bona fide purchaser status. See supra notes 92-93. Such secured creditors as well as transferees in “hold in custody” or “dealer safekeeping” repo transactions, where the securities are not transferred through a third party, necessarily bear the risks that the transferor-intermediary will fail and that there will be insufficient securities available to satisfy their claims. See Stigum, Repo, supra note 51, at 191-204 (discussing dealer safekeeping repos and less risky alternatives); supra notes 97-100 and accompanying text (discussing “proportionate property interest” rule); infra, Part III (discussing secured claims and customer claims in insolvency proceedings). The transferee also is exposed to the risk that its interest will not continue in proceeds of the collateral upon a disposition unless the proceeds are “identifiable.” U.C.C. § 9-306(2); see, e.g., Universal C.I.T. Credit Corp. v. Farmers Bank, 358 F. Supp. 317 (E.D. Mo. 1973) (application of “lowest intermediate balance rule” in determination of whether cash proceeds commingled in a bank account were “identifiable”). See generally B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code § 10.3, at 10-20 to 10-24 (1980 & Supp. 1990); R. Henson, Secured Transactions under the Uniform Commercial Code § 6, at 204-05 (1979); Note, Standards and Sanctions for the Use of Cash Collateral Under the Bankruptcy Code, 63 Tex. L. Rev. 341, 347 n.41 (1984) (“[T]he major limitation with respect to a security interest in proceeds is the ability of the secured party to trace the proceeds.”). Arguably, the standard for identification of proceeds should not be more strict than that applicable to the original transfer. See U.C.C. § 8-313(1)(d)(ii), § 8-313(1)(d)(iii).

\textsuperscript{122} The law is not clear as to whether a repo is an outright sale with an agreement to repurchase (as it is denominated) or a secured transaction. Compare Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. 557, 596-98 (D.N.J. 1986) (repo and reverse repo agreements were contracts for the sale and resale back to the original seller of securities) with Union Planters Nat’l Bank v. United States, 426 F.2d 115, 118 (6th Cir. 1970) (repo transactions were secured loans for Federal income tax purposes).
New York has amended its version of section 8-313 to make it clear that a secured party can be a transferee under section 8-313(1)(d) even though the financial intermediary also is the debtor. Any concerns about misleading appearances, even if justified in other contexts, appear to have little relevance when the debtor that remains in control of the collateral is a professional securities intermediary. A property law construct that denies the effectiveness and perfection of such a security interest, while giving effect to similar transfers of ownership interests, could only be grounded on an historical anomaly or a failure to appreciate the sui generis characteristics of the intermediary control phenomenon within the securities markets.

B. The Book Entry Treasury Regulations

For the most part, the foregoing discussion of transfer and pledge under Articles 8 and 9 also applies to the transfer and pledge of book-entry Treasury securities. But these transfers and pledges, gov-

and Westchester County Sav. & Loan Ass'n v. Legel, Braswell Gov't Sec. Corp. (In re Legel, Braswell Gov't Sec. Corp.), 648 F.2d 321, 324 n.5 (5th Cir. 1981) (repo is a short term collateralized loan even though it is in the form of a sale). See also Focht and Harbeck, Repurchase Agreements in Stockbrokerage Bankruptcies, 11 A.L.I.-A.B.A. Course Mat's J. 7, 10-12 (Oct. 1986) (repos should be characterized as secured transactions for bankruptcy purposes); Note, The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality, 36 Am. U.L. Rev. 669, 678-81 (1987) (characterization of repos by the courts has been inconsistent); Note, Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities, 37 Vand. L. Rev. 401, 415 (1984) ("[N]either courts nor federal regulatory bodies have given repos a clear legal characterization").

123 See N.Y. U.C.C. Law § 8-313(1)(d) (McKinney's 1990) (which includes the following italicized nonuniform language: "identifies as belonging to, or subject to a limited interest in favor of, the purchaser") (emphasis added); § 8-313(4) (which includes the following italicized nonuniform language in the definition of "financial intermediary": "and is either acting in that capacity or acting as transferee of a security or an interest in a security, irrespective (in either case) of whether such person is also acting in any other capacity.") (emphasis added).

124 Given the difficulties of anyone ascertaining the current status of securities controlled by an intermediary in a fungible bulk of securities and the various claims that exist with respect to such securities, it is hard to see how anyone could be misled by appearances. See supra note 109. Risks of fraud or debtor-creditor collusion may be more real. Cf. Mooney, The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases, 39 Ala. L. Rev. 533, 752-53 (1938) (prevention of fraud and collusion as to timing and veracity of secured transactions is an important function of the Article 9 filing rules). But there would not seem to be a greater likelihood for fraud in the intermediary-secured party context than in the intermediary-ownership customer context.

125 The market structure and operation of the closed system for book-entry government securities was described above. See supra notes 39-51 and accompanying text. The movement toward increasing the efficiency of trading in government securities, by eliminating the necessity of certificate deliveries, began more than fifty years ago. At first, provision was made for the transfer of securities between Federal Reserve banks by telegraph. Those transfers, called "CPDs," required the approval of the Treasury's Commissioner of the Public Debt. See Stigum, Trade, supra note 4, at 83-84. They eliminated the necessity of transporting securities
The Book-Entry Treasury Regulations,\(^{126}\) also present some special problems that underscore the deficiencies of a property law construct in a legal regime for fungible bulks of securities.

1. The "Bearer Definitive" Fiction on the Top Tier: Transfer and Pledge on the Fed's Books

Pursuant to the Book-Entry Treasury Regulations, transfers and pledges of interests in book-entry Treasury securities among DIs are subject to a Federal rule that does not, on its face, appear to involve state law.\(^{127}\) But this appearance can be deceptive. According to paragraph (a) of section 306.118, transfers reflected by entries in the Fed's books (such as by Fedwire) are deemed to have the effect of physical deliveries and receipts "in bearer form of definitive Treasury securities."\(^{128}\) The transferee or pledgee is deemed to be a "holder," and, in the case of a pledge, the pledgee's security interest is "perfected."\(^{129}\) Paragraph (a) provides a Federal rule that preempts state over long distances. For a brief description of the history of the Treasury security book-entry system, see id. Although the current book-entry system had its origin in the late 1960's, the full implementation of the book-entry system was accelerated in the early 1970's because of a crisis created by the possible loss of theft insurance coverage by securities dealers (resulting from several large thefts of securities). See id. at 36-88. The portion of the current book-entry Treasury Regulations dealing with the transfer and pledge of book-entry securities was last amended in 1972. 37 Fed. Reg. 8671 (1972).


\(^{127}\) 31 C.F.R. § 306.118(a) (1990). Paragraph (a) also applies to transfers and pledges between DIs and either the Fed or the United States government. Id.

\(^{128}\) Id.

\(^{129}\) Id.
law,\textsuperscript{130} although it leaves much to resolution under state law. For example, the regulations do not specify the effect of a “delivery” or of becoming a “holder,” and do not explain the effect of a security interest being “perfected.”\textsuperscript{131} To understand these effects, which are not altogether straightforward, resort must be taken to applicable state law.\textsuperscript{132}

As among DIs with book-entry securities accounts at the Fed, the “bearer definitive” fiction seeks to replicate the delivery of physical securities as well as the effects of a delivery. At the top tier, this fiction has worked fairly well because all participating transferors and transferees have accounts with the same intermediary (the Fed).\textsuperscript{133} Every transfer involves simultaneous and corresponding entries in the accounts of the transferee and the transferor. Transfers on the books of a clearing corporation provide the best state law analogue for transfers and pledges on the books of the Fed.\textsuperscript{134}

\textsuperscript{130} Transfers and pledges are “effected and perfected, notwithstanding any provision of law to the contrary.” 31 C.F.R. § 306.118(a) (1990).

\textsuperscript{131} Id.

\textsuperscript{133} Although the entries actually are made on the books of various reserve banks, for present purposes the book-entry system functions essentially as an integrated single intermediary.

\textsuperscript{134} Transferees on the books of clearing corporations, like DI transferees on the books of the Fed, also can achieve bona fide purchaser status. See Katzman, supra note 95, at 160-61, 178-79. Indeed, paragraph (a) was “explicitly modeled after . . . § 8-320.” Id. at 161 (citing Hoey & Rassnick, Automation of Government Securities Operations, 17 Jurimetrics J. 176, 181 (1976)); Memorandum of Law for the United States Treasury Department and the Federal Reserve Bank of New York, Wichita Fed. Sav. & Loan Ass’n v. Comark, 610 F. Supp. 406 (S.D.N.Y. 1985), modified, 610 F. Supp. at 418 [hereinafter Comark Memo], reprinted in Ringsmuth, supra note 87 at 76 n.9. For present purposes, the role of the Fed, as the issuer’s (federal government’s) fiscal agent, also is somewhat analogous to that of an issuer or transfer agent who maintains records of registered ownership of securities, except that only DIs may maintain accounts with the Fed in the book-entry system. See 31 C.F.R. § 306.116 (1990) (“Each Reserve Bank is hereby authorized, in accordance with the provisions of this subpart, to: (a) Issue book-entry Treasury securities by means of entries on its records . . . .”).
2. The “Bearer Definitive” Fiction on the Lower Tiers: Transfer and Pledge Under Applicable State Law

Courts, counsel, and commentators alike have been confounded in their attempts to interpret and apply the Book-Entry Treasury Regulations. Most of the difficulties have arisen in the context of transfers affecting at least one claimant that does not have (or is not claiming through) a book-entry securities account with the Fed.135 Such “lower-tier” transactions, not involving transfers on the books of the Fed, are governed by paragraph (b) of section 306.118 of the Book-Entry Treasury Regulations.136

The first sentence of paragraph (b) stipulates that the effectiveness of a transfer or pledge and the perfection of a pledge turn on compliance with what “applicable law” would require “if the securities were maintained . . . in bearer definitive form.”137 The second sentence then instructs that the securities are to “be deemed to be maintained in bearer definitive form.”138 The reference to “applicable law” in the first sentence means that state law controls.139

This “bearer definitive” fiction was intended to permit transfer and pledge under the law then applicable to securities—the pre-1978 Articles 8 and 9.140 Otherwise, paperless book-entry Treasury securities would have been characterized as “general intangibles,”141 with

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135 To put the discussion in the context of Example 1, imagine that I-3 is a DI clearing bank, I-2 is a non-DI primary government securities dealer, and I-1 is a regional securities firm. A non-DI dealer (such as I-2) normally finds it necessary to give a security interest to its clearing bank (I-3) covering securities “in” its clearing account on the books of its clearing bank (I-3) in order to secure daylight overdrafts and overnight loans. See supra note 50. In that case the clearing bank (I-3) is both the intermediary on whose books the interest of its customer (I-2) is reflected and a transferee of a security interest in the securities. The same point applies to the security interest given by I-1 to I-2 in Example 1. In addition, a customer (such as I-1) of a dealer (such as I-2) may desire to sell (pursuant to a repo arrangement or otherwise) or pledge to a third party (such as L) securities “in” its account on the dealer’s books (I-2’s books, in Example 1).


137 Id. The scope of paragraph (b) is limited to book-entry Treasury securities that are “maintained by a Reserve bank.” Id. (emphasis added). Presumably “maintained” means that the securities involved in lower-tier transfers under paragraph (b) must actually, in fact, be “in” the account of a DI on the books of the Fed. That interpretation is consistent with the approach under Article 8. See supra note 104.


139 See, e.g., Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. 557, 616-17 (D.N.J. 1986); Crespi, supra note 126, at 170-71; Katzman, supra note 95, at 167; Comark Memo, supra note 134, at 8.

140 See Healy & Rasmick, supra note 134, at 181; Katzman, supra note 95, at 167, 183.

141 See U.C.C. § 9-106; pre-1978 § 9-106 (defining “general intangible” as “any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money”); Heinieke Instruments Co. v. Republic Corp., 543 F.2d 700, 702 (9th Cir. 1976) (purchaser’s interest in stock prior to issuance of stock certificate was a general
transfers governed by the common law of assignment and perfection of security interests achieved by filing under Article 9. At first blush, book-entry Treasury securities would seem to be uncertificated securities under the 1978 Article 8. But the Fed does not undertake the role of an issuer, as contemplated by the 1978 Article 8, and uncertificated security treatment clearly would conflict with the "bearer definitive" fiction. Thus, whatever version of Article 8 applies, the "bearer definitive" fiction dictates that book-entry Treasury securities are deemed to be "certificated" securities (to use 1978 Article 8 terminology).

intangible). Because paperless securities are not "securities" under pre-1978 § 8-102(1)(a), they are not included in the Article 9 definition of "instrument." Pre-1978 §§ 8-102(1)(a), 9-105(1)(i); see Coogan, supra note 5, at 1020 & n.30.

Characterization of book-entry Treasury securities as general intangibles is precisely what the Department of Treasury sought to avoid by devising the "bearer definitive" fiction, because security interests in general intangibles can be perfected only by filing. U.C.C. § 9-302(1) (unchanged in the 1978 U.C.C.); see Hoey & Rassnick, supra note 134, at 181; Katzman, supra note 95, at 167, 183; see also Coogan, supra note 5, at 1021-22 & n.32 (suggesting that filing might be an appropriate means of perfecting a security interest in uncertificated securities in "run of the mill transactions," but acknowledging that perfection by entries on the books of intermediaries would be desirable "[i]f uncertificated securities become widely traded"). Aronstein, Haydock, and Scott effectively countered Coogan's arguments favoring a filing rule for uncertificated securities. Aronstein, Haydock & Scott, supra note 5, at 896-98 (arguing that a filing rule would impair essential attributes of negotiability).

Although there are disagreements at the margin, most observers agree that Article 9's perfection rules and its generally applicable first-to-file-or-perfect rule are useful because information is provided to prospective purchasers about the possible existence of conflicting claims and because protection is afforded to earlier-in-time secured parties. See U.C.C. §§ 9-301 to 305, 9-312(5)(a). See generally Baird, Notice Filing and the Problem of Ostensible Ownership, 12 J. Legal Stud. 53 (1983); Baird & Jackson, Information, Uncertainty, and the Transfer of Property, 13 J. Legal Stud. 299 (1984); Carlson, Rationality, Accident and Priority Under Article 9 of the Uniform Commercial Code, 71 Minn. L. Rev. 207 (1986) [hereinafter Carlson, Rationality]; Mooney, supra note 124; Phillips, Flawed Perfection: From Possession to Filing Under Article 9 (pts. 1 & 2), 39 B.U.L. Rev. 1 (1979). An Article 9-type filing system for interests in fungible bulk, securities, however, would be wholly unworkable (even aside from negotiability concerns) as a means of determining priorities among purchasers. First, to address effectively the potential priority contests, it would be necessary that the filing system be extended to absolute ownership interests, as well as security interests. Second, because the securities are fungible, it would be difficult to prepare collateral descriptions that would not be overbroad. Because securities intermediaries typically make transfers (as collateral and otherwise) to many transferees, broad filings (e.g., "all securities") would necessitate subordination agreements on a massive scale or exceptions to the first-to-file rule that would leave the conflicting priority issues largely unchanged. Finally, the high volume and velocity of transactions could overwhelm (or be overwhelmed by) any sort of filing regime heretofore seen by the world. To the extent that perfection by filing served only to confer priority against lien creditors (and a trustee in bankruptcy), rather than purchasers, a filing scheme might be feasible.

See Katzman, supra note 95, at 169, 182-83.

See supra notes 137-38 and accompanying text; Crespi, supra note 126, at n.66; Katzman, supra note 95, at 169-70. Arguably this conclusion is subject to some doubt where the 1978 Article 8 applies. The deemed certificated securities might be "re-certificated" to be uncertificated securities. See U.C.C. § 8-102(1)(c) ("If a certificated security has been retained by or
Because paragraph (b) does not address priorities, otherwise applicable state law applies to competing interests in securities transferred or pledged thereunder. And because book-entry Treasury securities are inherently a part of a fungible bulk, it follows that the Article 8 proportionate property interest formulation applies to a purchaser's interest. Thus, a purchaser of these securities, pursuant to a paragraph (b) transfer or pledge, cannot become a bona fide purchaser. Nevertheless, it is puzzling that paragraph (b) does refer to a "delivery" in the case of a third person acknowledgment contemplated by pre-1978 section 8-313(1)(d). One explanation for this surrendered to the issuer or its transfer agent for reasons other than registration of transfer, other temporary purpose, payment, exchange, or acquisition by the issuer, that security shall be treated as an uncertificated security for purposes of this Article."). A better view is that the "bearer definitive" fiction controls. See Katzman, supra, at 182-83 (U.C.C. § 8-102(1)(c) and duties of issuer under 1978 Article 8 are "antithetical to the Regulations' bearer certificate fiction and to the specific intent to insulate the Reserve Banks from any duty to register or acknowledge pledges.").

145 See Regulations Governing Book-Entry Treasury Bonds, Notes, and Bills, Summary of Department of Treasury, 51 Fed. Reg. 43027-41, 43035 (1986) [hereinafter November TRADES Summary] ("[B]ook-entry securities of the same issue are fungible and generally not subject to tracing."). The "bearer definitive" fiction in paragraph (b) does not state, and does not mean, that each transferee is deemed to have an interest in a discrete, particular, specific piece of paper.

146 See supra notes 97-100 and accompanying text.

147 See supra note 92. A delivery by identification of either a "specific security" in a broker's possession under pre-1978 § 8-313(1)(c) or U.C.C. § 8-313(1)(d)(i), or an acknowledgment concerning an "identified security" in a third person's possession pursuant to pre-1978 § 8-313(1)(d), requires an identification of a specific security that is incompatible with the inclusion of the security in a fungible bulk. For development of this point see infra notes 218-32; Appendix II, infra, notes 3-8. Whether applicable law is the pre-1978 or the 1978 Article 8, a delivery of book-entry Treasury securities cannot occur under 31 C.F.R. § 306.118(b) (1990) because applicable law makes no provision for a delivery of securities included in a fungible bulk. A contrary conclusion— that a delivery can occur in the case of a fungible bulk—would mean that the Book-Entry Treasury Regulations made a drastic change in the result under applicable state law. But § 306.118(b) makes no provision for transfer or delivery except pursuant to "applicable law." Where a different result was desired, as in 31 C.F.R. § 306.118(a) (1990), the regulations explicitly provide that a delivery occurs and holder status is attainable. See supra notes 127-29 and accompanying text. The Department of Treasury and the Federal Reserve Bank of New York have expressed a different view, however. See Comark Memo, supra note 134, reprinted in Ringsmith, supra note 87, at 92-93 (arguing that subaccounts or segregation of book-entry customer securities may provide an effective identification of a "specific" security under pre-1978 § 8-313(1)(c) and, therefore, bona fide purchaser status); Bradford Trust Memo, supra note 87, reprinted in Ringsmith, supra note 87, at 110-13 (same argument as to U.C.C. § 8-313(1)(d)(i)).

148 See 31 C.F.R. § 306.113(b) (1990) (where securities are recorded on an intermediary's books, that intermediary "shall, for purposes of perfecting a pledge . . . or effecting delivery of such securities . . . under applicable provisions of law, be the bailee to which notification of the pledge of securities may be given or the third person in possession from which acknowledgment of the holding of the securities for the purchaser may be obtained."). The quoted language obviously was derived from pre-1978 § 9-305 (perfection by notification to bailee) and pre-1978 § 8-315(1)(d) (delivery by acknowledgment of third person in possession of identified
anomaly is that the purpose of specifying an intermediary as the third person for purposes of an acknowledgment was to make clear that the Fed was not the proper person to make such acknowledgments. It is also plausible, even probable, that, in borrowing from the pre-1978 Article 8, the drafters of the Book-Entry Treasury Regulations simply did not focus on the bona fide purchaser issue.

In sum, the application of paragraph (b) requires, first, that the securities involved actually must be “in” a DI’s account with the Fed. Second, one must pretend that the book-entry securities are in “bearer definitive form” (although they are not). Third, one must look to “applicable law” of a state to determine how transfers and pledges of interests in a fungible bulk of bearer definitive securities are made effective, how pledges are perfected, and how priorities among conflicting claimants are determined. Although this description is adequate for present purposes, a host of other interpretive problems remain. It remains necessary to determine what state’s law is the “applicable law.” That determination may depend on the property classification given to the securities, and the “bearer definitive” fiction may not be decisive for this purpose. Determining the location of the deemed “bearer definitive” securities, which may turn on who is in fictional possession, also may affect the choice of applicable law. And the paragraph (b) terminology drawn from pre-1978 Articles 8 and 9 can be troublesome when the 1978 versions apply. Finally,

security). But, if pre-1978 § 8-313(1)(d) is properly construed, no delivery can occur when a fungible bulk is involved. See Appendix II, infra, notes 11, 41 and accompanying text.

149 See 31 C.F.R. § 306.113(b) (1990) (“A Reserve bank . . . is not a bailee for purposes of notification of pledges . . . or a third person in possession for purposes of acknowledgment of transfers . . . under this subsection.”).

150 Exact determination of this fact normally will be impossible, of course, since the securities are a part of a fungible bulk and a transferee could not discover the status of that bulk or the existence or absence of competing interests. See supra note 110. The risk that no transfer at all will occur is inherent. See supra notes 104-10 and accompanying text.

151 The Book-Entry Treasury Regulations offer no guidance as to the choice of law. Each of the two versions of Articles 8 and 9 is currently in effect in a substantial number of the states. See supra note 5. There are also various different versions of the U.C.C. Article 8 that have been enacted. Significantly, the important state of New York has enacted a version of the 1978 Article 8 that is different from the uniform version in a number of respects. See Correlation Tables U.C.C. Rep. Serv. (Callaghan) NY-6 to NY-12 (1986).

152 See Katzman, supra note 95, at 167:

A court easily might separate the two issues and consider the bearer certificate fiction to apply only after applicable law is chosen. In that case, in order to choose the applicable law, the court would have to decide for itself how to treat the securities. . . . Given this ambiguity, it cannot be predicted with certainty which jurisdiction’s law will apply.

For a discussion of choice of law in this context, including the various issues mentioned in the following text, see Katzman, supra note 95, at 160-85.

153 For example, acknowledgment by a third person in possession, a means of delivery
interpretive issues have arisen concerning the relationship between transfers under paragraph (a) and those under paragraph (b). 154

Several of these problems of interpretation and application inspired the Department of Treasury's Proposed TRADES Regulations. 155 Those regulations would scrap the "bearer definitive" fiction and reliance on state law in favor of a preemptive federal regime covering "all of the basic mechanical rules needed for effectively transferring Treasury book-entry securities and for perfecting security interests therein." 156 The Proposed TRADES Regulations would, however, strictly maintain a property law construct quite similar to the 1978 Article 8. 157

C. Observations

The foregoing discussion provokes several important observations that have not received explicit attention in earlier law reform efforts and commentary. Some of these observations have implications for the world outside of the securities markets.

Parsing through and applying the existing property law construct in the fungible bulk context is an enormously daunting task. Misunderstandings and disagreements exist even on some basic principles. Some of the difficulties arise from statutory language that might be drafted more clearly. Indeed, Appendix II demonstrates that 1978 section 8-313, when compared with the pre-1978 version, has been materially obfuscated where fungible bulks are concerned. 158 But the difficulty of interpreting and applying the property law construct reflects more than infelicitous drafting. Employing a property law construct in a context that differs so fundamentally from the environment in which property law principles arose and developed is a flawed technique that is bound to engender disarray. No one would think it wise or necessary to legislate that all unsecured creditors have a propor-

154 See, e.g., Comark Memo, supra note 134, at 74-84.
155 See supra note 7; March TRADES Summary, supra note 39, at 8847 (discussing defects and ambiguities in "bearer definitive fiction" and lack of uniformity resulting from two versions of Article 8).
156 March TRADES Summary, supra note 39, at 8847.
157 Two important priority rules included in the Proposed TRADES Regulations—the "good faith transferee" rule and the "clearing lien" priority—are discussed infra notes 233-41 and accompanying text, in connection with different-tier priority contests.
158 See Appendix II, infra, notes 39-45 and accompanying text.
tiationate property interest in all unencumbered assets of their common
debtor. Nor would anyone support a law to the effect that bank ac-
count depositors have a property interest in money or other property of a bank. Yet the treatment of transfer and pledge of interests in
fungible bulks of securities varies little from these analogies.

The common law’s baseline concept (nemo dat) results in a rule
of first-in-time-first-in-right. The proportionate property interest for-
mulation under Article 8 provides an alternative to first-in-time in
many circumstances, but even that sharing approach is undermined
by the potential for a “no transfer” result when an intermediary who
purports to effect a transfer actually controls no securities, or an in-
sufficient quantity, of the issue involved. In order to determine
whether an effective transfer of an interest in securities in fungible
bulk has occurred, application of the property law construct depends
on the actual existence of, and some identification of, the fungible
bulk of securities involved as well as an identification of any earlier-in-
time claimants. But in today’s securities markets fungible bulks can
be controlled by several tiers of intermediaries who participate in an
active market, and an intermediary may control more than one fungi-
ble bulk of securities at a given time. Settlements are routinely ef-
ected on a netted basis, and customers of an intermediary have no
feasible means of ascertaining either the status of the fungible bulks
against which they claim or the existence of any conflicting claimants.
It is not surprising, therefore, that application of a property law con-
struct is problematic.

Indeed, aside from flaws in application, a property construct,
however devised or modified, is likely to produce fortuitous, arbitrary,
and unpredictable results for customers who claim interests in fungi-
ble bulks of securities controlled by a common intermediary. Simi-
larly situated claimants may receive very different treatment. The
possibility of a “no transfer” result, again, is an apt example. Even
when the proportionate property interest formulation is applied, some
claimants (such as C-2 and C-3, in Example 1) may suffer a shortfall
and others (such as C-4) may be fully covered. This potential for
highly disparate treatment of different claimants would exist whether
the applicable property law principle were first-in-time, last-in-time
(such as bona fide purchase), or the proportionate property interest
formulation. That potential, especially because of the lack of knowl-
edge and control inherent in a claimant’s relationship with its inter-
mediary, means that the comfort and certainty normally associated
with the principles of first-in-time and bona fide purchase is chimeri-

159 See supra notes 104-10 and accompanying text.
cal where fungible bulks are concerned. When the benefits that derive from a property law construct are not present, any normative justifications for property law doctrine have diminished vitality.

There are other examples in commercial law that involve potential conflicting claims to finite resources where it has been useful to shrink from a strict property law approach. As commercial transactions and markets evolve and are made the subject of study, other proposals for non-property law construct approaches may well surface. Moreover, as the next part explains, for some, but not all, claimants in securities firm insolvency proceedings, the property law construct was largely abandoned many years ago.

III. CLAIMS AND DISTRIBUTIONS IN INTERMEDIARY INSOLVENCY PROCEEDINGS

It is only when an intermediary becomes subject to an insolvency proceeding that it will be necessary to explore the rights of a transferee of an interest in a fungible bulk of securities controlled by that intermediary. So long as the intermediary remains viable, the intermediary’s warranty and other obligations should ensure that the transferee receives the benefits of the securities that it claims. If the intermediary becomes unable to honor its obligations, actual enforcement of the transferee’s property rights against the intermediary outside of an insolvency proceeding is extremely unlikely.

160 See, e.g., Berger, An Analysis of the Doctrine That “First in Time is First in Right,” 64 Neb. L. Rev. 348, 357-58 (1985) (“One of the policies of our legal system is that of encouraging certainty, finality, or repose with respect to who has a right to a given resource. Such security is required so that persons can order their affairs upon certain assumptions concerning their rights and the rights of others.”). See, e.g., § 9-306(4)(d) (formula for determination and limitation of claims to cash proceeds in insolvency proceedings that overrides otherwise applicable allocation based on tracing principles).

161 See, e.g., Schwartz, A Theory of Loan Priorities, 18 J. Legal Stud. 209, 260 (1989) (proposing a priority scheme for creditors that, with certain exceptions, would award first priority to the unsecured lender whose loan was first-in-time because “something much like [that] priority rule would emerge as the equilibrium credit contract between initial financiers and borrowers”).

162 See generally Guttman, supra note 4, at 8-3 to -23; infra Part V(B).

163 See, e.g., U.C.C. § 9-313(3) (purchaser’s right to demand from financial intermediary a security not subject to notice of adverse claims); SEC Rule 15c3-3(i), 17 C.F.R. § 240.15c3-3(i) (1990) (customer’s “absolute right . . . to receive . . . physical delivery of certificates”).

164 Given the nature, supervision, and regulation of securities intermediaries, it is safe to assume that before a securities customer or secured creditor could judicially enforce its claims to securities that the intermediary could not honor (as opposed to enforcement when there is a dispute as to the claimant’s rights), the intermediary would be subjected to insolvency proceedings or replaced by regulators with another intermediary. See generally A. Follard, J. Pascale, K. Ellis & J. Daly, supra note 39, at 655-53 (failing and failed banks insured by FDIC);
cial nature of the institutions that serve as securities intermediaries distinguishes the transferee's property rights from those of most other property owners and secured creditors who not uncommonly assert and enforce property rights outside of insolvency proceedings. If the intermediary cannot perform, then the transferee often will recover only what it is entitled to receive in the intermediary's insolvency proceeding.\textsuperscript{167}

A. Ownership Claims of Customers: The SIPA and Bankruptcy Code Risk-Sharing Distributional Rule

Returning to Example 1, if state property law (Article 8) were to control in J-1's insolvency proceedings, each of J-1's customers claiming securities of a given issue would receive the benefit of a proportionate property interest in the fungible bulk of securities of that issue controlled by J-1. C-2 and C-3, then, would share pro rata in the insufficient quantity of C Co. securities and C-4 would be fully satisfied by the sufficient quantity of D Co. securities.\textsuperscript{168}

Because J-1 is a securities firm, SIPA and Subchapter III of chapter 7 of the Bankruptcy Code\textsuperscript{169} would impose a very different distributional result among same-tier claimants.\textsuperscript{170} Claims of custom-

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\textsuperscript{166} See supra notes 39-62 and accompanying text (discussing regulatory approach to intermediary risk).

\textsuperscript{167} In some cases the transferee also may have a conversion claim against a third party. See infra note 212. Part IV, infra, considers the troublesome different-tier priority conflicts that can result from intermediary insolvency but are not resolved by distributional rules applicable in insolvency proceedings.

\textsuperscript{168} See supra notes 97-100 and accompanying text (discussing proportionate property interest rule).


ers (including large claims in excess of coverage provided by SIPC\textsuperscript{171}) would be subject to a risk-sharing formula that differs from the Article 8 proportionate property interest formula. Instead of sharing a proportionate interest in the fungible bulk of securities of the issue claimed, divided among all claimants with claims to that issue, claimants that qualify for "customer"\textsuperscript{172} status share ratably, according to their respective "net equities,"\textsuperscript{173} in the entire pool of "customer property."\textsuperscript{174} In Example 1, if there is an insufficiency of customer property, all of the securities available to I-1 of the issues claimed by I-1's customers would be shared by all of I-1's customers (C-1 through C-5000)—including any customers that have no property interest at all under state law.\textsuperscript{175} This sharing rule represents a clear

\textsuperscript{171} When SIPA applies, the investors with smaller claims generally are fully protected by SIPC and, in many cases, larger amounts of private insurance. See supra note 8. Each customer is entitled to the benefit of advances from the SIPC fund, not exceeding $500,000, which can include advances on account of claims for cash not exceeding $100,000. SIPA, § 9(a), 15 U.S.C. 78ff-3(a) (1988); see Gutman, supra note 4, at 19-94 to 19-98.

\textsuperscript{172} "Customer" is defined in SIPA, in pertinent part, as:

\begin{quote}
[a]ny person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term "customer" includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities,...
\end{quote}


\textsuperscript{173} A customer's "net equity" is essentially the value of securities or cash claimed by the customer, as of the date the proceeding commenced, less claims of the debtor intermediary against the customer (such as unpaid customer obligations for securities purchased on "margin"). SIPA, § 16(11), 15 U.S.C. § 111(n); 11 U.S.C. § 741(6) (1988).

\textsuperscript{174} SIPA, § 8(c)(1), 15 U.S.C. § 78ff-2(c)(1); 11 U.S.C. § 752(a). Under both SIPA and Subchapter III, "customer property" includes virtually all securities available to the estate of the type that are subject to customer claims. SIPA, § 16(4), 15 U.S.C. § 78lll(4); 11 U.S.C. § 741(4). The principal exception is for property that is a "customer name security." An "customer name security" is a specific security held by the intermediary that is registered, or is in the process of registration, in the name of a customer and that is not in negotiable form. SIPA, § 16(3), 15 U.S.C. § 78lll(3); 11 U.S.C. § 741(3). Although the distributional formula for customer property is essentially the same under SIPA and the Bankruptcy Code, the means of satisfying the claims differ substantially. Under SIPA, the trustee distributes or purchases securities for distribution to customers. SIPA, § 8(d), 15 U.S.C. § 78ff-2(d). Under Subchapter III, the trustee reduces customer securities to money and then makes cash distributions to the customers. 11 U.S.C. §§ 748, 750, 752. Customer name securities, however, are distributed in kind to customers under both SIPA and Subchapter III. SIPA, § 2(c)(2), 15 U.S.C. § 78ff-2(c)(2); 11 U.S.C. § 751. For an enlightening discussion of the operation of the SIPA distributional rules for customer claims, see First Fed. Sav. & Loan Ass'n v. Bevill, Bresler & Schulman, 59 Bankr. 353, 358-73 (D.N.J. 1986).

\textsuperscript{175} Because customer status is given to those who have advanced cash to the debtor for the
break with the property construct that controls under state law.

The merits of the SIPA/Subchapter III risk-sharing rule have not been subjected to refined analysis. It is best seen as a specialized variation of the basic distributional formula applicable to creditors in bankruptcy—pro rata sharing among claimants who are similarly situated. 176 This principle often is expressed by the maxim "equality is equity." 177 Unlike property claimants such as lessors and secured creditors, the sui generis claims of customers of a securities intermediary are marked by a lack of control and knowledge and an almost exclusive reliance on the integrity and solvency of the intermediary (buttressed by regulatory constraints). 178

The origins of the SIPA/Subchapter III distributional rule indicate clearly that it is rooted in this notion of equal treatment. It derived from section 60e of the Bankruptcy Act, which was added by the Chandler Act of 1938. 179 Section 60e responded to widespread dissatisfaction with the essentially fortuitous, arbitrary, and disparate

purchase of securities, a customer may have a net equity claim, and thereby share in customer property, even though the customer has not received a transfer of a property interest under applicable state law. See SIPA, § 60.74, (2), 11 U.S.C. § 741(2); 11 U.S.C. § 741(2), (6) (1986).

176 See SIPA, § 726(a)(2), (b); Hill v. Spencer Sav. & Loan Ass’n, 94 Bankr. 817, 824 (D.N.J. 1989) ("SIPA contemplates equal distribution among similarly situated creditors.").

177 See, e.g., J. Macaulan, Bankruptcy 356 (1956) (It is "a general policy of bankruptcy that equality is equity between creditors of the same class.").

178 See supra notes 59-62, 110 and accompanying text.

179 Bankruptcy Act of 1938, § 60e, amended by Chandler Act, 11 U.S.C. § 96e, Pub. L. No. 75-696, 52 Stat. 840, 870 (1938) (repealed 1978). Section 60e established three kinds of claims for securities claimants in stockbroker bankruptcies. First, customers who could specifically identify their securities, or whose securities (or "substitutes therefor or proceeds thereof") were, more than four months prior to bankruptcy and while the debtor was solvent, "allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy," could reclaim the securities. 11 U.S.C. § 96e(2), (4) (repealed 1978); Collier on Bankruptcy, §§ 60.73, at 1171-72, 60.74, at 1182-89 (14th ed. 1977). Arguably, even securities in a fungible bulk, if physically set aside for a customer, could be so reclaimed. See Collier, supra, §§ 60.73, at 1187-89. Second, all other customers shared pro rata, according to the value of their "net equity" claims, in a "single and separate fund" comprised of all nonspecifically identifiable customer securities of all issues. 11 U.S.C. § 96e(1), (2) (repealed 1978); Collier, supra, § 60.73, at 1171-75. Third, to the extent that customer claims remained unsatisfied, customers received unsatisfied, general creditor status. 11 U.S.C. § 96e(1) (repealed 1978). SIPA and § 60e coexisted from 1970, when SIPA was enacted, until 1978 when SIPA was amended and Subchapter III, modeled on the amended SIPA, was enacted as a part of the Bankruptcy Code. Compare Securities Investor Protection Act of 1970, Pub. L. 91-598, 84 Stat. 1636 (1970) with Securities Investor Protection Act Amendments of 1978, Pub. L. 95-283, 92 Stat. 249 and The Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2682. Section 60e differed in detail from SIPA and Subchapter III, and it failed to resolve satisfactorily certain matters of scope and application. See, e.g., Gutman, supra note 4, at 19-60 to -67 (criticizing § 60e on the basis of ambiguity as to who is a "stockbroker" (an undefined term) and who is a "customer," and noting problems of tracing by cash customers); see also Note, Protection of the Accounts of Stockbrokerage Customers, 77 Harv. L. Rev. 1290 (1964).
treatment afforded stockbroker customers under applicable state law and the Bankruptcy Act.\textsuperscript{180} The essence of the distributional rule of section 60e—that customers share ratably in all customer securities—has been preserved by SIPA and Subchapter III.\textsuperscript{181}

Early drafts of what became Article 8 included a section that

\begin{quote}
Section 60e adopts the theory that all of the customers of a broker who permit him to have wide powers over their securities are subjecting themselves to the common risk of his failure. He should not be permitted to favor some over others when he and they contemplate the imminence of his failure. Furthermore, upon bankruptcy the available assets should be distributed by applying equitable principles upon a broader base than that recognized under pre-existing bankruptcy law.
\end{quote}

Under pre-§ 60e law, a distinction was drawn between cash customers and those who bought on margin, with the latter treated less favorably, and customers who could not trace their securities were given general creditor status. See Guttmann, supra note 4, at 19-38 to 40; Gilchrist, Stockbrokers' Bankruptcies: Problems Created by the Chandler Act, 24 Minn. L. Rev. 52, 53-57 (1939). Commenting on the (then-proposed but unenacted) Chandler Act, James McLaughlin noted:

\begin{quote}
Existing law turns upon refinements utterly unintelligible to the business man and involves elements of chance more appropriate to a beano party than to the administration of justice. If the problem be approached from the point of view of ease and economy of administration, the solution of the Chandler Bill warrants a high rating.
\end{quote}


Surprisingly, I have found no commentary that explicitly acknowledges the radical difference between the pre-1978 and 1978 § 8-313(2) proportionate property interest formulation, on one hand, and the risk-sharing approach of Bankruptcy Act § 60e, SIPA, and Subchapter III, on the other. Moreover, some commentary inexplicably appears either to miss the distinction entirely or to misinterpret one or the other scheme of allocation. For example:

Unlisted securities are delivered to the purchaser, they are held by the broker in fungible bulk. The customer is thus the owner of a proportionate property interest in the fungible bulk. In a bankruptcy of the broker, the customer would have his rights in the bulk determined by state law.

Guttmann, supra note 4, at 3-17 (footnote omitted).

If there be no specific security in the hands of the broker, the creditor customers will share pro rata in the fungible bulk, which will not be part of the bankrupt's assets; (Section 8-3-13(2) and Section 60(e) [sic] Bankruptcy Act) claiming any deficits as general creditors.

Of course the rules as to sharing in fungibles would be equally applicable here [in bankruptcy], unless there has been a setting aside of the stock to the customer's order, i.e., [pre-1978] Section 8-313(1)(b) or (c) or (d) are found applicable. The most important aspect of Section 8-313 is thus seen to be in the realm of bankruptcy law.


\textsuperscript{180} See, e.g., Maclachlan, supra note 177, at 323 (quoted in Guttmann, supra note 4, at 19-41):

\begin{quote}
Section 60e adopts the theory that all of the customers of a broker who permit him to have wide powers over their securities are subjecting themselves to the common risk of his failure. He should not be permitted to favor some over others when he and they contemplate the imminence of his failure. Furthermore, upon bankruptcy the available assets should be distributed by applying equitable principles upon a broader base than that recognized under pre-existing bankruptcy law.
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\textsuperscript{181} Surprisingly, I have found no commentary that explicitly acknowledges the radical difference between the pre-1978 and 1978 § 8-313(2) proportionate property interest formulation, on one hand, and the risk sharing approach of Bankruptcy Act § 60e, SIPA, and Subchapter III, on the other. Moreover, some commentary inexplicably appears either to miss the distinction entirely or to misinterpret one or the other scheme of allocation. For example:

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Of course the rules as to sharing in fungibles would be equally applicable here [in bankruptcy], unless there has been a setting aside of the stock to the customer's order, i.e., [pre-1978] Section 8-313(1)(b) or (c) or (d) are found applicable. The most important aspect of Section 8-313 is thus seen to be in the realm of bankruptcy law.
explicitly dealt with distributions of securities upon a broker’s insolvency and generally incorporated the section 60e approach. The drafters subscribed to the underlying principle of the section 60e risk-sharing rule on both cost-saving and normative grounds. One commentary equated the risk-sharing principle to the “admiralty principle of ‘common venture-common risk.’” The coexistence of the draft

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182 See Commercial Code, Tentative Draft No. 1—Article V, § 33 (May 10, 1947), reprinted in 3 Uniform Commercial Code Drafts 287-88 (E. Kelly ed. 1984); Commercial Code, Tentative Draft No. 2—Article V, § 33 (August 28, 1947), reprinted in 3 Uniform Commercial Code Drafts, supra, at 533-34; Commercial Code, Proposed Final Draft No. 1—Article V, § 29 (April 26, 1948), reprinted in 4 Uniform Commercial Code Drafts, supra, at 342-43; Commercial Code, Proposed Final Draft No. 2—Article V, § 20 (August 9, 1948), reprinted in 5 Uniform Commercial Code Drafts, supra, at 205-06; U.C.C., May 1949 Draft, Article 8—Investment Securities, § 8-316, reprinted in 8 Uniform Commercial Code Drafts, supra, at 243-44. Each of these drafts also contained a provision contemplating that a broker’s customer would obtain a proportionate property interest in a fungible bulk. See Appendix II, infra. The first draft of the investment securities article was a partial draft and did not contain a provision for distributions in broker insolvency proceedings. Commercial Code, Preliminary Tentative Draft No. 1—Article V (April 22, 1946), reprinted in 3 Uniform Commercial Code Drafts, supra, at 1-44. Although there were several variations in the broker insolvency distribution scheme among the cited draft provisions, they differed from Bankruptcy Act § 60e primarily in their proposed reintroduction of the distinction between cash customers and margin customers. See, e.g., U.C.C., May 1949 Draft, Article 8—Investment Securities, § 8-316(1), reprinted in 8 Uniform Commercial Code Drafts, supra, at 243-44.

183 See, e.g., Commercial Code, Tentative Draft No. 2—Article V, Note to § 33 (August 28, 1947), reprinted in 3 Uniform Commercial Code Drafts, supra note 182, at 561:

The purposes of the section are, first, to reduce the expense, delay and uncertainty which derive from an effort to apply the uncertain and conflicting rules of bona fide purchase and of tracing to the unravelling of the manipulations of a common fiduciary; and, second, to achieve real equity in the situation in which several persons have put their trust, in common, in a defalcator. The reason is clear: once defalcation has set in, it is a matter of pure accident which securities become the particular objects of plunder, and the common risk should be shared, instead of being left to accident.

U.C.C., May 1949 Draft, Article 8—Investment Securities, § 8-316(1) comment 1, reprinted in 8 Uniform Commercial Code Drafts, supra, at 244:

By adopting the basic policy of Section 60 E [sic] of the Federal Bankruptcy Act which makes provision for a pro rata distribution among a bankrupt broker’s customers as a separate class, the time consuming and costly “tracing” technique normally employed when a common fiduciary is guilty of misappropriation and malfeasance is avoided.

184 Commercial Code, Proposed Final Draft No. 1—Article V, note to § 29 (April 26, 1948), reprinted in 4 Uniform Commercial Code Drafts, supra note 182, at 382. The quoted reference obviously refers to the admiralty law doctrine of “general average” contribution. See generally G. Gilmore & C. Black, The Law of Admiralty 384-71 (3d ed. 1975). When general average applies, the interests of a ship’s owners in the ship and their right to compensation for carriage (“freight”) and the interests of the owners of the cargo share ratably any loss or damage to any of their interests. Id. at 244-45. The doctrine is not applied to all such loss or damage, but only when three conditions are satisfied. First, there must be a danger or peril that is common to the “ship, cargo and crew” and that is “inevitable, except by voluntarily incurring the loss of a portion of the whole to save the remainder.” Id. at 245 (quoting Barnard v. Adams, 51 U.S. (10 How.) 270, 303 (1859)). Second, a portion of the interests (such as
U.C.C. section and the generally applicable proportionate property interest rule indicates that the drafters did not view the latter rule to be directed to insolvency distributions at all.\footnote{185} This risk-sharing rule for insolvency distribution eventually was dropped from Article 8 on the grounds that modifications to section 60e were preferable to changes in state law, not on the basis that the principle was flawed.\footnote{186}

The potential for cost savings may offer a plausible basis for pro rata sharing among general creditors.\footnote{187} But it is doubtful that costs would be materially increased if the Article 8 proportionate property interest formulation were applied in securities firm insolvencies.\footnote{188}

Aside from cost savings, does pro rata sharing, either in the SIPA/
Subchapter III context or more generally, serve to maximize the collective wealth of creditors? The answer seems to be uncertain, at best, and highly controversial. The post-bankruptcy effect of the SIPA/Subchapter III approach is purely distributional—it takes the value of customer securities of some issues away from customers claiming those issues and distributes that value to other customers claiming other issues. The aggregate value of customer securities and the aggregate amount of customer claims are the same with or without the rule.

Customers well might include a risk sharing arrangement similar to the SIPA/Subchapter III distributional formula in a hypothetical ex ante collective bargain because that formula furnishes customers with a higher likelihood of a lower potential loss. Even so, this does not prove that the SIPA/Subchapter III risk sharing rule has a mate-

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190 Thomas Jackson approves of pro rata sharing among general creditors because it is consistent with what he claims a hypothetical creditors’ bargain would produce and it “mimics the value of [creditors'] expected positions immediately before bankruptcy, at least given that the rule must be fashioned in the absence of information about the creditors involved.” T. Jackson, The Logic and Limits of Bankruptcy Law 31 (1986). The quoted statement reflects a truism. Obviously, once it is assumed that prior to bankruptcy all creditors have equal opportunities for a recovery, pro rata sharing would “mimic the value” of the creditors claims. But that assumption cannot be true. For an earlier exposition of the creditors' bargain paradigm see, e.g., Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain, 91 Yale L.J. 857 (1982). The paradigm is grounded on the notion that creditors, each entitled to their ex ante legal rights and priorities, would agree among themselves to vary those rights in a collective bankruptcy proceeding only when the result would be a collective maximization of wealth. It would follow that if the bankruptcy process redistributes the assets of the firm in a way that not only varies from the creditors’ pre-bankruptcy entitlements, but also varies from the hypothetical creditors’ bargain, it is normatively unsound. For a strong criticism of Jackson’s creditors’ bargain paradigm, see Carlson, Book Review, 85 Mich. L. Rev. 1341 (1987) (reviewing T. Jackson, supra). Carlson “suggest[s] that equal priority may be a normative idea put in place to confirm desired creditor conduct, rather than the product of what creditors really want separate from law.” Id. at 1356 n. 43.

191 So long as the customers allow the intermediary to control the securities they retain little control themselves. See supra note 110. When the intermediary’s insolvency proceeding begins, the customer property might contain few securities (or none) of one issue and enough securities of another issue to satisfy all customer claims to that issue. Application of the proportionate property interest scheme in such largely fortuitous circumstances could result in highly disparate treatment of various customers. But, because of the regulation and supervision of securities intermediaries, including the customer protection rules, it is less likely that the customer property in the aggregate would fall to a very low percentage of the customers’ net equities (although that has happened in the case of small firms). Telephone Interview with Michael E. Don, Deputy General Counsel and Secretary, Securities Investor Protection Corporation (Oct. 17, 1989). Thus, the risk sharing approach makes it less likely that a customer would sustain a severe loss. A similar analysis may explain the willingness of market participants to share risks in the clearing and settlement process. See supra note 12.
rrial impact on the behavior of an intermediary or its customers. For example, strategic eve of bankruptcy behavior by the intermediary, or a dominant customer, that would favor a particular customer or group of customers to the detriment of other customers could undermine the collective wealth maximization of the group.\textsuperscript{193} But it is plausible that the adoption of either the risk sharing or the proportionate property interest approach would not have a pronounced effect on the behavior or expectations of securities intermediary customers. Customers whose claims are excluded from or would exceed the limits of SIPC protection are predictably highly risk averse and likely to view the effect of an insolvency proceeding for their securities intermediary as intolerable, whatever the formula for distributions of customer securities.\textsuperscript{193} Thus, it can be expected that these claimants will select intermediaries that they believe are virtually certain to remain viable.\textsuperscript{194} If that certainty turns to doubt, these investors will likely demand that their securities be held or acquired for them by another intermediary.\textsuperscript{195} The potential for eve of bankruptcy strategic behavior by customers of a failing intermediary can best be addressed by application of preference law.\textsuperscript{196}

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\textsuperscript{192} See, e.g., Jackson & Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 Va. L. Rev. 155, 171-74 (1989). In their article Thomas Jackson and Robert Scott suggested that a risk sharing analysis based on the "common disaster" context of admiralty law's general average contribution rule may provide a normatively justifiable explanation for various distributional rules under the Bankruptcy Code. Id. passim. In particular, they invoked the analogy to general average contribution as an illustration that risk sharing in bankruptcy may be an effective means to control eve of bankruptcy strategic behavior by a dominant secured creditor. See id. at 171-74. The common disaster analysis draws on Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901, 967-68 (1986) [hereinafter Relational Theory], and Scott, Through Bankruptcy with the Creditors' Bargain Haurista, 13 U. Chi. L. Rev. 690, 700-07 (1986) [hereinafter Through Bankruptcy]. For critiques of the Jackson and Scott article, see Elenkyberg, Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining, 75 Va. L. Rev. 203 (1989); Rom, Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics, 75 Va. L. Rev. 219 (1989). For reasons already explained, the general average contribution principle is an apt metaphor for the SIPA/Subchapter III sharing scheme. See supra note 184.

\textsuperscript{193} Both the risk sharing approach and the proportionate property interest rule yield the potential for dilution of customers' claims.

\textsuperscript{194} See supra notes 34-35 and accompanying text.

\textsuperscript{195} I find it incomprehensible that a customer with actual concerns about the financial condition or integrity of its intermediary would fail to demand delivery or movement of securities while basking in the comforting glow of a prospective application of the SIPA/Subchapter III sharing formula.

\textsuperscript{196} Preferences are governed by 11 U.S.C. § 547 (1988), which also applies in SIPA proceedings. SIPA, § 6(b), 11 U.S.C. § 741(f) (1980); 11 U.S.C. § 547; see also SIPA, § 9(a)(3), 15 U.S.C. § 78ff-5(a)(1) (trustee may recover property transferred by debtor that would have been customer property except for transfer, if transfer is voidable or void under Bankruptcy Code); 11 U.S.C. § 749(a) (to the same effect in a Subchapter III case). A transfer is voidable under § 547 of the Bankruptcy Code only if, later in, it is made within 90 days before comm
Notwithstanding the controversy as to the basis for and effects of pro rata sharing in bankruptcy, there seems to be general satisfaction with the risk sharing approach among customers in securities firm insolvencies as well as with pro rata sharing in bankruptcy among general creditors and among other similarly situated classes of creditors. Certainly the "equality is equity" maxim—embraced by pro rata sharing—reflects a widely held normative view.197 Similarly, the seniority afforded to securities firm customers (as measured by customer property) over general creditors reflects, in turn, that only the debtor's property will be available for distribution to its creditors.198

If the SIPA/Subchapter III risk sharing approach is sound for securities firm insolvency proceedings, it would seem that it also should be made applicable to insolvencies of other intermediaries, such as banks.199 But customer property in the custody of insolvent

197 For example, although Jackson's and Carlson's respective views of bankruptcy are very different, each agrees with the result produced by the baseline pro rata sharing rule. See, e.g., T. Jackson, supra note 190, at 29-31; Carlson, supra note 190, at 1355-59 n. 43.
198 See 11 U.S.C. § 341 (specifying what constitutes "property of the estate"); § 725(a) (distributions of "property of the estate").
199 It is not necessary to dwell on the legal framework applicable to insolvent banks under United States federal and state laws. See generally A. Pollard, J. Pasracic, K. Ellis & J. Daly, supra note 59, at 603-23 (failing and failed banks covered by FDIC). Note that certain features of the federal scheme for insolvent depository institutions recently have been modified.
banks generally is allocated according to otherwise applicable state property law.200 In the case of customer securities held by an insolvent bank in a fungible bulk, the proportionate property interest formula would apply. Modifying section 8-313(2) to incorporate the SIPA/Subchapter III sharing rule could impose that result in bank insolvency proceedings without the need to change laws applicable to those proceedings.

B. Claims of Secured Creditors

As a general matter, a securities firm’s creditors who claim security interests in securities are not “customers” and their treatment under SIPA or Subchapter III is not unlike the treatment given secured creditors generally under the Bankruptcy Code.201 Because the substantially. See, e.g., Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 212, 103 Stat. 183 (1989), (amending Federal Deposit Insurance Act, § 11, 12 U.S.C. § 1821 [1988]). The merits of the risk sharing formula would be essentially the same as for securities firms. Yet some might take exception to that conclusion because banks normally maintain separate fungible bulks for trust department customers. See supra note 103. Those customers might feel disadvantaged by a rule that would mandate sharing with non-trust department securities customers. One plausible response would be to create a separate class of “similarly situated” trust department customers who would share all trust department securities rather than applying the proportionate property interest formulation on an issue-by-issue basis.

200 It seems to be well accepted that property in the hands of a failed bank that is identifiable as belonging to customers or others does not become a part of a failed bank’s estate available for distribution to creditors. See, e.g., FDIC v. Mademoiselle of California, 379 F.2d 660, 664-65 (9th Cir. 1967) (owner of participation interest in bank loan is entitled to identifiable collections made by FDIC as receiver for failed bank); accord Chase Manhattan Bank, N.A. v. FDIC, 554 F. Supp. 251, 254 (W.D. Okla. 1983). In practice, the FDIC routinely turns over assets held in trust, custody or safekeeping to claimants whose interests can be adequately identified. Telephone interviews with Carroll R. Shiflett, Assistant General Counsel, Federal Deposit Insurance Corporation (May 15 and June 29, 1989). Nothing in the law applicable to failed federally insured banks has been found that would upset a state law distributional scheme (such as the proportionate property interest formula) for allocating such property among rightful claimants. Were state law changed to provide for a SIPC/Subchapter III-type risk sharing formula, that formula would be applicable in the case of a failed bank that controlled customer securities. See supra notes 182-86 and accompanying text (discussing such a distributional rule applicable to failed brokers in early U.C.C. drafts). However, the virtual absence of customer losses on account of property held in custody by banks suggests that presently there is lacking a sufficient concern so as to inspire changes in law. See supra note 55.

201 A secured party that receives physical delivery of collateral or to whom the collateral is transferred through another, third party, intermediary, is not a “customer” because it has no “claim on account of securities received, acquired, or held by the debtor.” SIPA, § 16(2), 15 U.S.C. § 78lll(2) (1988); 11 U.S.C. § 741(2) (1988); see supra note 172. If a secured creditor of the insolvent intermediary had allowed that intermediary to control the securities that comprise the collateral and its security interest were determined to be perfected, the secured party would seem to fit the plain meaning of the definition of “customer” under both SIPA and the Subchapter III. Both definitions expressly include as customers persons claiming securities that are “received, acquired, or held . . . in the ordinary course of . . . business . . . as collat-
secured creditor would not be a "customer", it would not share in the pool of customer property. Awarding a same-tier secured creditor with the benefit of securities that otherwise would be included in the customer property, however, would give its security interest a priority that would not be enjoyed outside of an insolvency proceeding, but this appears to be the result under current law. Subordinating the secured creditor's claim to those of the customers also could have a distributional effect equally inconsistent with otherwise applicable law. If the risk sharing distributional formula is superior, arguably treatment of such (same-tier) secured creditors as customers would...
produce the most desirable result.204

C. Observations

It is not necessary, here, to resolve the various policy and interpretive puzzles arising in securities intermediary insolvency proceedings.205 The foregoing discussion does offer a clearer vision, from both positive and normative perspectives, of the nature of claims to securities controlled by an intermediary in fungible bulk. Because the actual enforcement of property interests against financial institution

204 By enlarging the aggregate amount of claims to customer property, however, increased demands could be placed on the SIPC fund in cases where securities of the issues claimed by secured creditors were scarce. See supra notes 173-74. Suffice it to note that the subject of same-tier priority conflicts and distributional considerations as among securities customers and secured creditors warrants further practical and theoretical exploration.

205 In recent years several bankruptcy scholars have explored the theoretical bases for bankruptcy law. See, e.g., T. Jackson, supra note 190; Baird, supra note 189; Baird & Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97 (1984); Eisenberg, supra note 192; Eisenberg, Bankruptcy Law in Perspective, 28 UCLA L. Rev. 953 (1981); Carlson, Postpetition Interest Under the Bankruptcy Code, 43 U. Miami L. Rev. 577 (1989); Harris, A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective, 30 UCLA L. Rev. 327 (1982); Jackson & Scott, supra note 192; LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. Rev. 311; McCoid, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 Va. L. Rev. 249 (1981); Roe, supra note 192; Roe, Bankruptcy and Debt: A New Model for Corporate Reorganization, 83 Colum. L. Rev. 527 (1983); Scott, Through Bankruptcy, supra note 192; Shanker, The Use and Abuse of Federal Bankruptcy Power, 26 Case Western L. Rev. 3 (1975); Warren, supra note 189; Carlson, supra note 190; Eisenberg, A Bankruptcy Machine that Would Go of Itself (Book Review), 39 Stan. L. Rev. 1519 (1987) (reviewing T. Jackson, supra). A related and somewhat overlapping body of commentary has emerged that considers, and sometimes questions, the role of and need for secured credit and its priority over claims of general creditors, both in and out of insolvency proceedings. See, e.g., Ayer, On the Vacuity of the Sale/Lease Distinction, 68 Iowa L. Rev. 657 (1983); Baird, supra note 142; Baird & Jackson, supra note 142; Buckley, The Bankruptcy Priority Puzzle, 72 Va. L. Rev. 1393 (1986); Carlson, Rationality, supra note 142; Jackson & Kronman, Secured Financing and Priorities Among Creditors, 88 Yale L. J. 1143 (1979); Jackson & Schwartz, Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke, 133 U. Pa. L. Rev. 987 (1985); Kripke, Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact, 133 U. Pa. L. Rev. 929 (1985); Phillips, supra note 142; Phillips, The Commercial Culpability Scale, 92 Yale L. J. 228 (1982) [hereinafter Phillips, Culpability]; Schwartz, supra note 162; Schwartz, The Continuing Puzzle of Secured Debt, 37 Vand. L. Rev. 1051 (1984); Schwartz, Security Interests and Bankruptcy Priorities: A Review of Current Theories, 10 J. Legal Stud. 1 (1981); Scott, Relational Theory, supra note 192; Shupack, Solving the Puzzle of Secured Transactions, 41 Rutgers L. Rev. 1067 (1989) [hereinafter Shupack, Puzzle]; Shupack, Defending Purchase Money Security Interests Under Article 9 of the UCC from Professor Buckley, 22 Ind. L. Rev. 777 (1989); White, Efficiency Justifications for Personal Property Security, 37 Vand. L. Rev. 473 (1984). The bankruptcy and secured credit discourse has ignored insolvency proceedings of financial intermediaries, such as securities firms and banks, including SIPA and Subchapter III proceedings. Perhaps the discourse concerning bankruptcy theory and secured credit and that concerning securities intermediary failures could be advanced by connecting the two, but that effort must await another day.
intermediaries outside of insolvency proceedings is unlikely, it is the entitlement in those proceedings that is material.\textsuperscript{206} If the intermediary performs as expected, the claimants receive the desired benefits of a property interest. If the intermediary fails, their claims may be enormously reduced in value. Consequently, the most powerful determinant of outcome in the market seems to be the selection of an intermediary. This description underscores the obvious similarities between fungible bulk securities claimants and claims of creditors generally.

In sharply breaking with the state law property construct, the SIPA/Subchapter III distributional formula exemplifies a model that should be embraced more generally by the legal regime for transfer and pledge of interests in fungible bulks of securities. It overrides the arbitrary and fortuitous “no transfer” result and the disparate customer treatment provided by the Article 8 proportionate property interest formula.\textsuperscript{207} But it does not apply when the insolvent intermediary is a bank. Nor does it override these results in the case of fungible bulks of securities that are also claimed by owners and creditors who do not claim an interest in the fungible bulk through an account with the insolvent intermediary—claimants on different tiers. In that scenario, addressed next, the existing property law construct can interfere with the interests of market participants who, unlike the insolvent intermediary’s customers, did not cast their common lot with that intermediary.

\textsuperscript{206} Stated otherwise, customers of securities firms cannot rationally expect the proportionate property interest formulation to be applied in the case of a shortfall. At least as a matter of bankruptcy theory, resolution of the Baird-Warren debate about whether prebankruptcy entitlements should be favored over purely distributional bankruptcy rules is of diminished importance in the context of the SIPA/Subchapter III risk sharing approach. See Baird, supra note 189; Warren, supra note 189. Voluntary prebankruptcy transfers and deliveries of securities that enable customers to improve their positions can be dealt with by adjustments preference law. See supra note 196. Because the dominant element of the customers’ bargain with the intermediary is that there are to be sufficient securities on hand to satisfy all customer claims, the proportionate property interest rule is best explained not as a distributional rule but merely a conventional property law conceptualization that links the customers’ interests to a fungible bulk that the intermediary is expected to maintain. Indeed, the proportionate property interest approach is consistent with the general common law approach to commingled property. See, e.g., R. Brown, The Law of Personal Property §§ 6.8-6.9, 6.13 (3d ed. 1975) (discussing common law doctrine of confusion); Frisch, U.C.C. Section 9-315: A Historical and Modern Perspective, 70 Minn. L. Rev. 1, 14-21, 41 (1985) (discussing common law doctrine of confusion and treatment of interests in commingled property).

\textsuperscript{207} See supra notes 104-109 and accompanying text.
IV. COMPETING CLAIMS AND PRIORITIES ON DIFFERENT TIERS: BONA FIDE PURCHASE, FIRST-IN-TIME, LAST-IN-TIME

The priority contests between C-1 and I-2 and between C-1 and L, in Example 1, illustrate conflicting claims among claimants on different tiers. There are several possible approaches for sorting out these claims under current law.\(^{208}\)

Note first that distributional rules in I-1’s insolvency proceeding would not resolve these priority contests. In a SIPA or Subchapter III proceeding the risk sharing distributional rule would pool C-1’s claim to “customer property” with claims of all other customers.\(^{209}\) But because the securities in Example 1 would not be “customer property” to the extent they are subject to the perfected security interests of L and I-2, these priority contests would not be resolved by the SIPA/Subchapter III risk sharing formula.\(^{210}\) Nor would that formula apply if I-1 were a bank or other intermediary not subject to SIPA or Subchapter III.\(^{211}\) Resort to applicable state law would be necessary to resolve the priority contests. Were C-1’s interest determined to be senior, C-1 could recover the A Co. securities from L and the B Co. securities from I-2, or the respective values of C-1’s interests, on a conversion theory.\(^{212}\)

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\(^{208}\) Were things to work as they are supposed to, such shortfalls in available securities would not occur. Shortfalls may result from error, fraud, or intentional or inadvertent noncompliance with applicable customer protection rules. See supra notes 59-68.

\(^{209}\) See supra notes 174-77 and accompanying text.

\(^{210}\) L and I-2 are not “customers” of I-1 under either SIPA or Subchapter III. See supra notes 172-201.

\(^{211}\) See supra notes 170, 199-200 and accompanying text.

\(^{212}\) See Morgan Guar. Trust Co. v. Third Nat’l Bank, 400 F. Supp. 333, 388-89 (D. Mass. 1975) (Article 8 envisions common law conversion suits, citing pre-1978 §§ 1-103, 8-318), aff’d, 529 F.2d 1141 (1st Cir. 1976); Hartford Accident & Indem. Co. v. Walston & Co., 21 N.Y.2d 219, 234 N.E.2d 230, 237 N.Y.S.2d 58 (1967) (conversion action against stockbroker permitted (under pre-U.C.C. law) where stockbroker failed to observe reasonable commercial standards). C-1’s right to recover on a conversion theory would not necessarily be defeated by I-2’s or L’s good faith or absence of notice of C-1’s claim. See Nickles, Enforcing Article 9 Security Interests Against Subordinate Buyers of Collateral, 50 Geo. Wash. L. Rev. 511, 524-25 (1982) (“A buyer’s status as a good faith purchaser for value without knowledge of the security interest does not absolve him of liability. If the secured party is entitled to priority and possession under Article 9’s rules, the converter’s pure heart and clear conscience are ordinarily irrelevant.” (citation omitted)). However, to the extent that I-2 was acting as an agent for J-1, as in connection with the transfer to L of the A Co. securities, if I-2 acted “in good faith (including observance of reasonable commercial standards . . .)” it would have a defense to a conversion claim by C-1. U.C.C. § 8-318 and pre-1978 § 8-318. But that defense would not protect I-2 while acting in its capacity as a secured party if C-1’s interest in the B Co. securities were determined to be senior.
A. First-in-Time Transfers to Upper-Tier Claimants

Assume initially that the security interests claimed by L and I-2 were created and perfected before C-1’s purchase of the A Co. and B Co. securities.\(^{213}\) As to the A Co. securities claimed by both L and C-1, C-1 probably did not receive an effective transfer because, at the time of the putative transfer to C-1, the A Co. securities earlier pledged to L were not “shown on the account of” I-1 “on the books of” I-2.\(^{214}\) However, because the B Co. securities claimed by both I-2 and C-1 continued to be “shown on the account of” I-1 on the books of I-2 (albeit subject to I-2’s security interest), the transfer to C-1 of those securities would be effective.\(^{215}\) Thus, the details of how securities accounts are structured and denominated may determine whether C-1 receives an effective transfer of a property interest in securities at all.\(^{216}\)

Assuming that effective transfers to C-1 occurred, C-1’s interest in the respective fungible bulks of A Co. and B Co. securities would be junior to the interests of L and I-2 unless C-1 were a bona fide purchaser.\(^{217}\) C-1, as a transferee of an interest in a fungible bulk, could not be a bona fide purchaser.\(^{218}\) Any argument that C-1 became a bona fide purchaser because it received a transfer under section 8-313(1)(d)(i)\(^{219}\) should fail. I-1 is not in “possession” of the securities

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\(^{213}\) The following discussion assumes that the security interests of I-2 and L are perfected, although L’s security interest would not be perfected under the facts of Example 1 if the pre-1978 Articles 8 and 9 were applicable. See supra note 118.

\(^{214}\) U.C.C. § 8-313(1)(d)(iii). If I-2’s books had reflected I-1’s ownership interest as well as L’s security interest, however, then a transfer to C-1 could have occurred. Likewise, had L’s security interest been perfected merely by notification to I-2, presumably the securities would have continued to be shown on I-1’s account. See id. § 8-313(1)(h)(i) (perfection by notification to debtor’s financial intermediary).

\(^{215}\) See id. § 8-313(1)(d)(iii).

\(^{216}\) Had the B Co. securities claimed by I-2 and C-1 been transferred to a proprietary account of I-2, rather than an account in I-1’s name, I-2 also might successfully argue that there was no effective transfer to C-1. On the other hand, there might have been an effective transfer to C-1 of both the A Co. and the B Co. securities, regardless of the account nomenclature, if the books and records of I-2 somehow reflected I-1’s beneficial ownership and that the transfers to L and I-2 were merely secured transactions.

\(^{217}\) U.C.C. §§ 8-301(1), 8-302(3); see supra notes 90-91 and accompanying text. The same result would obtain if C-1 were a perfected secured party rather than an outright buyer either through application of name date or because I-2 and L would have been the first to perfect. See U.C.C. § 8-313(5)(a).

\(^{218}\) U.C.C. § 8-313(2) (first sentence); supra note 92.

\(^{219}\) Transfer of uncertificated securities pursuant to § 8-313(1)(d)(i) can confer bona fide purchaser status, id. Such a transfer would require that I-1, in addition to sending C-1 a confirmation of the purchase, “by book entry or otherwise identify[y] as belonging to . . . [C-1] a specific uncertificated security in . . . [I-1’s] possession.” U.C.C. § 8-313(1)(d)(i). Pre-1978 § 8-313(1)(ie) is essentially identical to U.C.C. § 8-313(1)(d)(i), except that the pre-1978 version dealt with what constitutes a “delivery” rather than what constitutes a “transfer.”
within the meaning of section 8-313(1)(d)(i)\textsuperscript{220} (although there is authority that could support a contrary conclusion based on “constructive possession”\textsuperscript{221}) and the securities are a part of a fungible bulk,

\textsuperscript{220} Although Example 1 states that I-3 is in physical possession of the securities (assuming they are certificated), C-1 could be expected to argue that I-1 is in constructive possession as a result of its agency relationship with I-2 and I-2’s agency relationship with I-3. See infra note 221. But the better construction of paragraph (d)(i) is that when securities are a part of a fungible bulk shown on the account of a transferee’s intermediary (such as I-1) on the books of that intermediary’s upstream intermediary (such as I-2), the transferee’s intermediary (I-1) is not in possession of the securities. Paragraphs (d)(i) and (d)(ii) each cover certificated securities “in the financial intermediary’s possession,” and there is no reason to believe that “possession” has a different meaning in paragraph (d)(i) from that in paragraph (d)(ii). If that language were construed to embrace generally the concept of constructive possession through upstream intermediaries, then paragraph (d)(iii) would be rendered essentially superfluous as to certificated securities; transfers of certificated securities that otherwise would be covered by paragraph (d)(iii) would always be covered by paragraph (d)(ii). Even if this interpretation is not accepted, I-1 might be deprived of constructive possession by virtue of the preexisting security interests in favor of L and I-2. See In re Paragon Sec. Co., 599 F.2d 351, 356-57 (3d Cir. 1979) (suggesting that lien on securities granted by intermediary to upstream intermediary would deprive intermediary of control necessary for constructive possession pursuant to pre-1978 § 8-313(1)(c)); Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. 557, 609-12 (D.N.J. 1986) (security interest in favor of intermediary’s upstream intermediary together with contractual restrictions deprived intermediary of control necessary for constructive possession pursuant to pre-1978 § 8-313(1)(c) and U.C.C. § 8-313(1)(d)(i)).

\textsuperscript{221} See Louisiana State School Lunch Employees Retirement Sys. v. Legel, Braswell Gov’t Sec. Corp., 699 F.2d 512, 515 (11th Cir. 1983); Levy v. Chemical Bank (In re Scott, Gorman Municipals, Inc.), 36 U.C.C. Rep. Serv. (Callaghan) 283, 286 (S.D.N.Y. 1983); Matthias v. Securities Processing Servs., Inc., 444 F. Supp. 1009, 1017-18 (S.D.N.Y. 1977) (intermediary’s constructive possession through upstream intermediary pursuant to pre-1978 § 8-313(1)(c)); see also Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. at 512-15 (intermediary in constructive possession, through upstream intermediary, of securities (in which upstream intermediary did not have a security interest) pursuant to pre-1978 § 8-313(1)(c) and U.C.C. § 8-313(1)(d)(ii)). Aronstein believes the results in the Legal, Braswell, Scott and Gorman cases, are “anomalous, but correct.” Aronstein, Investment Securities, 39 Bus. Law. 1375, 1385 (1984). In my view I-1 could be in constructive possession for those purposes only if I-2 had been a transferee of the securities from I-3 pursuant to 1978 section 8-313(1)(c) or (d)(ii), and I-2 had, in turn, effected such a transfer to I-1. Such transfers would constitute deliveries to I-2 under pre-1978 § 8-313(1)(b) or (c). Under both versions of § 8-313, such transfers or deliveries could qualify I-2 for bona fide purchaser status. Pre-1978 and U.C.C. § 8-313(2) (first sentence); U.C.C. § 8-301(1). I-2, then, would be in constructive possession so as to retransfer or redeliver securities to I-1. But none of the transfers in Example 1 were effected under pre-1978 § 8-313(1)(b) or (c) or U.C.C. § 8-313(1)(d)(ii) because fungible bulk were involved. See supra note 92; infra notes 222, 224. Thus, neither I-2 nor I-1 could have achieved constructive possession. The root of the misunderstanding may be the unjustified reliance in Matthias on Le Marchant v. Moore, 130 N.Y. 209, 44 N.E. 770 (1896), for the proposition that a downstream intermediary can effect a delivery to its customer notwithstanding possession of securities by an upstream intermediary. See Matthias, 444 F. Supp. at 1016-19. Le Marchant involved title to securities, not delivery. Indeed, the customers of the downstream intermediary in Le Marchant obtained title subject to an earlier pledge in favor of the upstream intermediary. That case cannot support the argument that the downstream customer can become a bona fide purchaser. Matthias relied on the New York Annotation to pre-1978 § 8-313(1)(c) which, also erroneously, indicated that Le
making identification of a “specific security” impossible.222

Prior to 1985 the cases that found an identification of a specific security had occurred involved physically identified certificated securities (i.e., specific pieces of paper).223 But recent decisions indicate that, for purposes of 1978 section 8-313(1)(d)(i) or pre-1978 section 8-313(1)(c), an identification of a specific security can occur in the case of treasury securities that are inherently a part of a fungible bulk.224


222 See Aronstein, Security Interests, supra note 116, at 297, 304 (identification of a “specific security” under pre-1978 § 8-313(1)(c) is not possible when a broker holds a fungible bulk, such as a “‘jumbo certificate’ representing the interests of a number of customers in the same issue,” and U.C.C. § 8-313(1)(d)(i) embraces pre-1978 § 8-313(1)(c)). There can be no doubt that the securities involved in Example 1 are a part of a fungible bulk possessed by or registered to i-3 and allocated pursuant to book entries on the books of I-3, I-2 and I-1. Certainly book entries and business records of a securities intermediary that allocate to different customers or creditors certain quantities of securities controlled by the intermediary do not change the nature of a fungible bulk. The fungibility would be affected only by some action that identified a particular, distinguishable, portion of the bulk that was owned by a particular customer. With certificated securities that would be possible only by identifying particular certificates. See generally infra notes 228-31 and accompanying text.

223 Louisiana State School Lunch Employees, 699 F.2d at 513-14 (specific certificated securities prepared for mailing by upstream intermediary at downstream intermediary’s instruction); Matthysse v. Securities Processing Servs., Inc., 444 F. Supp. at 1014 (specific certificated securities prepared for mailing and identified by upstream intermediary, on delivery forms, by certificate number and names of downstream intermediary’s customers); see also Levy, 36 U.C.C. Rep. Serv. (Callaghan) 287 (remanded for determination of whether “client tag numbers” on intermediary’s “buy tickets” covering certificated securities in physical possession of upstream intermediary constituted identification of specific securities). The Legal, Braswell, Scott, Gorman, and Matthysse cases each involved pre-1978 § 8-313(1)(c).

224 See Wichita Fed. Sav. & Loan Ass’n v. Comark, 610 F. Supp. 406, 416-18 (S.D.N.Y. 1985) (question of fact raised as to identification under pre-1978 § 8-313(1)(c); modified, 610 F. Supp. at 418; Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. at 605-09 (identification under U.C.C. § 8-313(1)(d)(i) and pre-1978 § 8-313(1)(c)); In re Lion Capital, 49 Bankr. 163, 187-88 (Bankr. S.D.N.Y. 1985) (possibility of identification under U.C.C. § 8-313(1)(d)(i)). For a discussion of those cases and those cited supra note 223, see Crespi, supra note 126, at 171-85; see also Katzman, supra note 95, at 168, 173-75. Upon reargument and consideration of the Comark Memo, supra note 134, the Comark court stated that “in order to mitigate any possible harm to the government securities market caused by . . . [the court’s opinion on this point], we conclude that the . . . opinion should not be treated as an authoritative interpretation of the federal and state law provisions there construed.” Wichita Fed. Sav. & Loan Ass’n v. Comark, 610 F. Supp. at 419. Meanwhile, the Lion Capital opinion had been issued relying substantially on the Comark opinion. In re Lion Capital, 49 Bankr. at 186-88.

Although the pre-1978 Article 8 applied only to securities evidenced by certificates and § 8-313(1)(d)(i) applies only to “certificated securities,” the “bearer definitive” fiction imposed by the book-entry Treasury Regulations requires book-entry treasury securities to be treated as if they are certificated. Treas. Reg. § 305.118(b); U.C.C. § 8-313(1)(d)(i); pre-1978 § 8-102(1)(a) (defining “security” as “an instrument”). See generally supra notes 135-44 and accompanying text. Because a transference of an interest in a fungible bulk of securities cannot become a bona fide purchaser under either version of Article 8 as applied through the current
The opinions in these cases, the arguments of the parties and amicus curiae, and the subsequent commentary generally focused on whether an identification could result from the actions of a claimant’s intermediary (such as I-1 for C-1) alone or whether, when the securities were subject to a security interest in favor of that intermediary’s upstream intermediary (such as I-2), action of the upstream intermediary (I-2) would be necessary for an identification to occur.\textsuperscript{225} I would have thought this was relatively clear. Both the 1978 and pre-1978 statutory language state clearly that it is a transferee’s intermediary (I-1 for C-1) alone that can effect a transfer or delivery (to C-1) by its confirmation and identification.\textsuperscript{226} There are, as well, compelling practical and policy justifications for this interpretation.\textsuperscript{227}

Book-Entry Treasury Regulations, it follows that no one can become a bona fide purchaser of book-entry Treasury securities except a depository institution that has an account with a Federal Reserve Bank. See supra note 92; 31 C.F.R. § 306.118(a) (1990) (depository institution that receives a transfer of securities in its account with a Federal Reserve Bank can be a “holder.”). Nevertheless, the Comark, Bevill, Bresler and Lion Capital cases did not follow this reasoning. The Bevill, Bresler court recognized that U.C.C. § 8-313(1)(d)(iii) could be applied to the book-entry Treasury securities involved, but its connection of that thought with its focus on transfer under paragraph (1)(d)(i) was not clear. See Cohen v. Army Moral Support Fund (\textit{In re} Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. at 615-16. It may have considered, incorrectly, the only difference to be the requirement of possession in U.C.C. § 8-313(1)(d)(i). Id.

\textsuperscript{225} See, e.g., Wichita Fed. Sav. & Loan Ass’n v. Comark, 610 F. Supp. at 416-18; Cohen v. Army Moral Support Fund (\textit{In re} Bevill, Bresler & Schulman Asset Management Corp.), 67 Bankr. at 606-09; Comark Memo, supra note 134, at 17-20, 23; Crespi, supra note 126, at 175-84.

\textsuperscript{226} Identification is a condition precedent to transfer, set forth in the \textit{chapeau} to U.C.C. § 8-313(1)(d), which applies to transfer under paragraphs (1)(d)(i), (ii), and (iii) alike. The language clearly contemplates that the identifying intermediary is to be the same intermediary that sends a confirmation (normally the downstream intermediary unless the upstream intermediary does so as an agent). Paragraph (1)(d)(iii) also unambiguously indicates that it is a transferee’s immediate intermediary, and not that intermediary’s upstream intermediary, that is to satisfy the identification requirement. There is no suggestion in the statutory language that identification under paragraph (1)(d) has a different meaning for purpose of paragraphs (1)(d)(i), (ii), and (iii). Similarly, pre-1978 § 8-313(1)(c) provides that “delivery to a purchaser . . . occurs when . . . his broker sends him confirmation . . . and . . . identifies a specific security . . .” (emphasis supplied). However, an intermediary could satisfy the identification requirement by causing its (upstream) intermediary to effect an identification. See Louisiana State School Lunch Employees Retirement Sys. v. Legel, Braswell Gov’t Sec. Corp., 699 F.2d at 513-14; Matthesse v. Securities Processing Servs., Inc., 444 F. Supp. at 1014. Consent or action by an upstream intermediary that claims a security interest in the securities also may bear on the issue of the downstream intermediary’s possession, however. See supra note 220.

\textsuperscript{227} Requiring participation or consent by upstream intermediaries in the process of identifying securities would undermine the very efficiencies sought to be achieved by facilitating transfers on the books of intermediaries. It would mean that an intermediary could not transfer a security to a transferee pursuant to U.C.C. § 8-313(1)(d) unless the intermediary’s upstream intermediary (and, presumably, all other intermediaries further upstream) were also to make book entries or somehow identify the interests of all downstream claimants. For a persuasive explanation of how such a requirement would be unduly burdensome to the securities markets,
The appropriate question is not how or by whom an identification is to be made but what is to be identified—a “specific” security. Identification of a “specific” security, in this context, must mean the identification of a particular, discrete certificate evidencing a certified security that is the subject of the transfer. It cannot plausibly be construed to mean an allocation to a transferee of an undivided interest in a quantity of securities included in a fungible bulk. The drafting history of pre-1978 paragraph (1)(c) makes it clear that this interpretation of “specific” is the correct one. The drafters contemplated that deliveries pursuant to pre-1978 paragraph (1)(c) would be unusual and normally would occur only during the process of preparing certificates for actual physical delivery to a broker’s customer. A transfer of an interest in a fungible bulk of securities on the books on an intermediary bears little resemblance to transfer by physical delivery of a certificated security. Consequently,

see Cohen v. Army Moral Support Fund (In re Bevill, Breeler & Schulman Asset Management Corp.), 67 Bankr. at 607-08. The Bevill, Breeler court’s explanation is sound, as is its conclusion that identification can be achieved by the action of the downstream intermediary alone. Id., at 608-09. But it misses a turn when it appears to assume that unless book entry transfers by intermediaries can be made pursuant to U.C.C. section 8-313(1)(d)(i) or pre-1978 § 8-313(1)(c) they cannot be made at all.

228 U.C.C. § 8-313(1)(d)(i); pre-1978 § 8-313(1)(c). Although Katzman never squarely takes a position on whether a non-DI transferee of an interest in inherently fungible book-entry treasury securities can become a bona fide purchaser, and he fails to answer the question of whether such securities can ever be “specific” securities within the meaning of pre-1978 § 8-313(1)(c) or U.C.C. § 8-313(1)(d)(i), he did pose the right question. See Katzman, supra note 95, at 169.


230 Were 1978 paragraph (1)(d)(i) construed otherwise it would swallow paragraphs (1)(d)(ii) and (iii)—if the possession and identification requirements are met in Example 1, it would be hard to imagine a transfer under paragraph (1)(d)(ii) or (iii) that would not also satisfy paragraph (1)(d)(i). The reference to identification “by book entry or otherwise” in the caption to paragraph (1)(d) does not weaken the argument that paragraph (1)(d)(i) applies only to the identification of a particular piece of paper. U.C.C. § 8-313(1)(d). For example, a book entry could identify a specific certificated security by its certificate number. See United States v. Doyle, 486 F. Supp. at 1219. Nor is the argument weakened by paragraph (1)(f), which provides for a transfer of a “specific uncertificated security” by a non-financial intermediary registered owner’s acknowledgment, although the drafters left to our imagination the rationale for this curious use of “specific.” U.C.C. § 8-313(1)(f). Note also that paragraph (1)(f)’s analogue for certificated securities, paragraph (1)(e) (which is substantially the same as pre-1978 § 8-313(1)(d)), refers to an “identified certificated security” but does not use the word “specific.” U.C.C. § 8-313(1)(e). I suspect that the inconsistent language is a result of inadverence. See Appendix II, infra, notes 39-45.

231 See Appendix II, infra, notes 3-8, 21-25 and accompanying text.
barring a transferee such as C-1 from bona fide purchaser status is hardly remarkable. Nevertheless, the Department of Treasury and the Federal Reserve Bank of New York have expressed a different view.232

The Proposed TRADES Regulations would provide a different result for Treasury securities—one that would establish a “last-in-time” priority. Unless I-2’s security interest were to qualify for priority as a “clearing lien,”233 I-2’s interest in the B Co. securities would be subordinated to C-1’s claim. Assuming C-1 purchased the securities “for value, in good faith, and without notice of any adverse claim,” C-1 would be a “good faith transferee”234 and would acquire an interest in the B Co. securities “free of any adverse claim which arose prior to the transfer of such interest to” C-1.235 Why the Treasury Department opted for this last-in-time rule is unclear.236

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232 See supra note 147. One possible explanation for this disagreement may be the New York Fed’s misconception that delivery was a necessary condition for an effective transfer of property rights under the pre-1978 Article 8. See supra note 87. Political expediency is another possible explanation. See infra note 237.

233 See Proposed TRADES Regulations, supra note 7, § 357.3 (defining “clearing lien” as “a security interest granted to a clearing bank or Federal Reserve Bank, pursuant to a written agreement, to secure credit extended in providing clearing services,” “clearing services” as “delivering and receiving securities and payments for securities on behalf of other persons,” and “clearing bank” as “a depository institution . . . which has a book entry securities account at a Federal Reserve Bank through which it provides clearing services”). Under Proposed TRADES Regulations, supra, § 357.15(a), “[a] clearing lien in a security shall have priority over all other claims of third parties to that security including claims of a transferee that qualifies as a good faith transferee . . . .” Exceptions to this priority are made for security interests in favor of the United States pursuant to section 357.19 (e.g., priority for security interests securing deposits of public money, deposits to the Department of Treasury for tax and loan accounts) and clearing liens in favor of a Federal Reserve Bank. Id. Section 357.15(b) further limits the clearing lien priority “to the extent of credit actually extended in performing clearing services” and to liens that are perfected and “acquired in good faith.” Proposed TRADES Regulations, supra, § 357.15(b). The proposed priority for clearing liens is grounded on the crucial role played by clearing banks in the market for Treasury securities and the enormous intraday credit exposure of the clearing banks. See, e.g., November TRADES Summary, supra note 145, at 43035 (“[E]xtensions of credit [by clearing banks] must be fully collateralized to satisfy the safety and soundness requirements of the bank regulators.”); Stigum, Trade, supra note 4, at 181 (“To anyone familiar with the mechanics of clearing and with the handling of dealer loans, the case made by clearing bankers [for a failsafe clearing lien] seems strong.”); Crespi, supra note 126, at 186 (“It is essential for the continued efficient functioning of the government securities market that clearing agent security interests be made secure against divestment by unilateral customer actions.”). See generally supra notes 46-51 and accompanying text.

234 Proposed TRADES Regulations, supra note 7, § 357.14(a).

235 Id. § 357.14(b).

236 The proposal of preemptive federal priority rules was a complete turnabout from the approach taken in the March Proposed TRADES Regulations. The November TRADES Summary described the reasons for rejecting a bona fide purchase rule in the March Proposed TRADES Regulations.
the good faith transferee rule allows a lower-tier transferee of an interest in a fungible bulk of securities to cut off adverse claims, the rule represents a striking departure from both the pre-1978 and 1978 Article 8 treatment of fungible bulk transferees on the books of intermediaries.\footnote{See Proposed TRADES Regulations, supra note 7, \S 357.14(e); U.C.C. \S 8-313(2) \& pre-1978 \S 8-313(2) (second sentence). The seeming incongruity of imposing such a sharing rule, however, applicable among good faith transferees of a common intermediary, similar to the proportionate property interest rule of section 8-313(2).} The rights of a good faith transferee are diluted by a sharing rule, however, applicable among good faith transferees of a common intermediary, similar to the proportionate property interest rule of section 8-313(2).\footnote{See Proposed TRADES Regulations, supra note 7, \S 357.14(e); U.C.C. \S 8-313(2) \& pre-1978 \S 8-313(2) (second sentence). The seeming incongruity of imposing such a sharing rule, however, applicable among good faith transferees of a common intermediary, similar to the proportionate property interest rule of section 8-313(2).} In an insolvency proceeding of I-1 under...
SIPA or the Bankruptcy Code, however, the applicable customer distribution rules would override the result of the good faith transferee rule of the Proposed TRADES Regulations. In such a proceeding, although the secured claims of I-2 and L probably would achieve priority over the claim of C-1, I-2 and L could remain vulnerable to a suit by C-1 for conversion.

Even if the good faith transferee rule were to give C-1’s claim to B Co. securities priority over that of I-2, L’s claim to A Co. securities would not be cut off because, as under Article 8, no effective transfer to C-1 would occur as to those securities. In one case C-1 would achieve priority over an upper-tier secured creditor and in another case C-1 would receive no effective transfer.

There is another possible solution to this priority contest. Because C-1 is claiming an interest in the same fungible bulks claimed by, respectively, L and I-2, arguably the proportionate property interest rule of section 8-313(2) would apply. Such an application would result in ratable sharing of the A Co. securities between C-1 and L and the B Co. securities between C-1 and I-2. One case and one commentator have indicated that this is the proper interpretation of current law. However, that interpretation of section 8-313(2) would...
seem to be based solely on a literal, but implausible, reading. 244 This is not what the drafters of any version of Article 8 had in mind. 245 The proportionate property interest rule should be reserved for claims of those claiming through a common intermediary. Here, only C-1 is claiming through an account with I-1. 246

B. First-in-Time Transfers to Lower-Tier Claimants

Now assume that the transfers to C-1 occurred before, rather than after, the creation of the security interests in favor of L and I-2. I-2 would not acquire its security interest in the B Co. securities free of C-1’s claim because I-2 would not be a bona fide purchaser. 247 If, on the other hand, I-2 were in physical possession of the securities involved, then I-2 could achieve bona fide purchaser status. 248 And, if I-3 were a clearing corporation, it is arguable that I-2 could become a

244 U.C.C. § 8-313(1)(d)(iii) applies to a transfer of an interest in securities that are a part of the transferee’s intermediary with “another” intermediary. U.C.C. § 8-313(1)(d)(iii). U.C.C. § 8-313(2), then, refers to “the fungible bulk.” U.C.C. § 8-313(2).

245 From the very first draft of Article 8 (then Article V), the proportionate property interest concept was to apply as among customers of the same intermediary. See Commercial Code, Preliminary Tentative Draft No. 1—Article V, § 13 (April 22, 1946), reprinted in 3 Uniform Commercial Code Drafts, supra note 182, at 20 (quoted in Appendix II, infra, note 2). The comments to U.C.C. § 8-313 reflect a similar conceptualization. See U.C.C. § 8-313, comment 4 (describing proportionate property interest rule of § 8-313(2) as applicable as among customers of the same intermediary). Moreover, the proportionate property interest concept would not apply as among customers and secured creditors of an insolvent intermediary under SIPA or Subchapter III. See generally supra Part III.

246 Neither I-2 nor L have an account with, nor have they allowed I-1 to control, securities in which they claim an interest. L has allowed only I-2 to control the securities it claims and I-2 has allowed I-3 to control the securities that it and L claim.

247 U.C.C. §§ 8-301(1), 8-302(1), (3); pre-1978 § 8-301(1), (2). Example 1 assumes that I-3, not I-2, is in physical possession of the certificated securities involved, and there could not be a delivery under U.C.C. § 8-302(1)(a). I-2, originally a transferee on the books of I-3 pursuant to U.C.C. § 8-313(1)(d)(ii), should not be annotated with constructive possession for purposes of bona fide purchaser status. See supra notes 218-31 (similar argument concerning C-1 as a transferee pursuant to U.C.C. § 8-313(1)(d)(iii)). I-2 also is not the registered owner of uncertificated securities or a transferee pursuant to U.C.C. § 8-313(1)(e), (d)(ii), or (g). I-2 is a transferee of a security interest from I-3 pursuant to U.C.C. § 8-313(1)(f). See supra notes 113, 115. Thus, U.C.C. § 8-302(1)(b) and (e) do not apply. U.C.C. § 8-302(b), (e).

248 This conclusion assumes that the securities are “in bearer form or in registered form, issued or indorsed to” I-2. § 8-302(1)(a). That I-2 took delivery before it became a purchaser of a security interest from I-1 should not change this result. Although the transfer to I-2 would be pursuant to § 8-313(1)(f), nothing in § 8-302(1)(a) or § 8-313(1) makes bona fide
bona fide purchaser as to the transfer of a security interest in B Co. securities from J-1 to J-2.\(^{249}\) It seems odd that J-2's manner of controlling the securities—possession or non-possession—could determine whether J-2 achieves priority over C-1's interests. Neither C-1 nor C-1's intermediary, I-1, can dictate (other than by contract) or even ascertain (in the case of fungible bulks) how J-2 chooses to control the securities involved. But this result is inherent in the Article 8 property law construct. A bona fide purchaser cuts off all adverse claims, upper-tier and lower-tier, but transferees that are not bona fide interest free of mine might argue, however, that the securities it claims were first controlling the securities involved. But this result is inherent in the Article 8 property law construct. A bona fide purchaser cuts off all adverse claims, upper-tier and lower-tier, but transferees that are not bona fide purchasers are subject to the first-in-time doctrine.

L also would not qualify for bona fide purchaser status.\(^{250}\) L might argue, however, that the securities it claims were first transferred by J-1 to I-2, and then from I-2 to L. L would further argue that J-2 was a bona fide purchaser, and that L received its security interest free of C-1's claim under the "shelter" principle.\(^{251}\) That argument would face some difficult hurdles. First, I-2 could not be a bona fide purchaser unless I-3 were a clearing corporation.\(^{252}\) Second, it is not clear that there were two transfers involved (one from J-1 to I-2 and one from I-2 to L) when J-1 granted a security interest to L.\(^{253}\) Third, even if two transfers did occur, it is not clear that J-2 gave "value" so as to qualify for bona fide purchaser treatment.\(^{254}\) If

purchaser status depend on a delivery occurring at or subsequent to the time a transferee becomes a purchaser.

\(^{249}\) If I-3 were a clearing corporation, I-2 could have become a bona fide purchaser when the securities were originally transferred to it on the books of I-3. U.C.C. §§ 8-313(1)(g), (2) (first sentence), 8-320(3); pre-1978 §§ 8-313(1)(e), (2) (first sentence), 8-320(3). But the transfer of a security interest from J-1 to I-2 occurs under U.C.C. § 8-313(j) without any I-3 book entry and is not a transfer under U.C.C. §§ 8-313(1)(g) and 8-320. Yet it seems odd to deny bona fide purchaser status to J-2, an earlier transferee on the books of a clearing corporation, since Article 8 generally treats such transfers as equivalent to a delivery. Id. A transferee under pre-1978 §§ 8-313(1)(e) and 8-320 becomes a "holder" and such a transfer "has the effect of a delivery of a security in bearer form or duly indorsed in blank." Pre-1978 §§ 8-313(2), 8-320(3). Under the pre-1978 Article 8, then, I-2 would be deemed to be in physical possession of the securities at the time of J-1's transfer of a security interest to I-2 and, consequently, could become a bona fide purchaser. Pre-1978 § 8-302(1); Guttman, supra note 4, at 8-29 to -30. There does not appear to have been any intention for the U.C.C. Article 8 to change this result. See U.C.C. § 8-320, Reasons for 1977 Change ("Subsection (3) has been rewritten to address certain consequences directly, rather than merely by analogy to the physical delivery of certificated securities.").

\(^{250}\) As a transferee of an interest in a fungible bulk of securities on the books of an intermediary (I-2), L could not be a bona fide purchaser for the same reasons that C-1 could not be a bona fide purchaser. See supra notes 222-35 and accompanying text.

\(^{251}\) See U.C.C. and pre-1978 § 8-301(1) & comment 1; supra note 88; see also U.C.C. and pre-1978 § 8-313(3).

\(^{252}\) See supra note 249.

\(^{253}\) See infra note 375 (suggesting that there may be two transfers in the context of transferee warranties, although the issue is not free of doubt).

\(^{254}\) See U.C.C. and pre-1978 § 8-302(1) ("'bona fide purchaser' is a purchaser for value
L’s shelter principle argument fails because I-2 is not a bona fide purchaser, L might continue to assert that I-2 (L’s intermediary) was L’s immediate transferee and that I-2 had breached a transferor warranty.255 If that claim were successful, then I-2 would bear the loss even though it was not involved in either the original transfer to C-1 (on C-1’s books) or (except to act as C-1’s and L’s intermediary) the subsequent secured loan from L to C-1.256

Finally, two other theories, not derived from Article 8, may offer L and I-2, as subsequent transferees, some hope of achieving seniority over C-1. First, prior to the transfer to C-1 on the books of I-1, presumably I-2 controlled the securities for its customer, I-1, through I-2’s intermediary, I-3. By leaving I-1 (and the upstream intermediaries) in control of the securities, arguably C-1’s interest could be subordinated to all subsequent transferees on estoppel or apparent authority grounds. That theory probably would not be successful.257 Second, L and I-2 could argue that I-1 is a trustee for C-1, as beneficiary, and that trust law applies to I-1’s transfers of the securities, as trust property. A good faith purchaser for value of trust property from a trustee normally takes free of a beneficiary’s equitable ownership claim, provided that the purchaser does not have notice of a

255 See generally infra Part V(B).

256 I-2 also might make a transferor warranty claim against I-1 under this “two transfer” paradigm. But because of I-1’s insolvency I-2’s recovery as an unsecured creditor would be uncertain.

257 The U.C.C. does not generally abolish the doctrines of estoppel and apparent authority. See U.C.C. § 1-103. Traditionally, estoppel has been viewed as an “application of the rules of fair play.” In re King Memorial Hospital, Inc., 19 Bankr. 885, 891 (Bankr. D. Fla. 1982). Estoppel of an owner from recovering property from a good faith purchaser requires voluntary conduct on the owner’s part which leads the purchaser to change its position to its detriment. 31 C.J.S. Estoppel § 59(a), at 367 (1964 & Supp. 1990). For example, an owner may be stopped from recovering its property from a good faith purchaser if, by its act or omission, the owner entrusts possession to and vests apparent ownership in the seller. MBank-Waco, N.A. v. L. & J., Inc., 754 S.W.2d 245, 251 (Tex. Ct. App. 1988). The doctrine of apparent authority allows an agent to bind its principal when the principal gives its agent the appearance of authority and the agent, using that authority, commits a fraud on an innocent third party. Restatement (Second) of Agency § 281 (1958); 2A C.J.S. Agency § 157(a), at 787 (1972 & Supp. 1990). The doctrine of apparent authority sometimes is said to be a specific application of the more general doctrine of estoppel. See, e.g., 2A C.J.S. Agency § 157(c), at 789 (1972 & Supp. 1990). In Example 1, L would argue that by choosing I-1 as its intermediary, C-1 vested apparent authority in I-1 and, therefore, C-1 is estopped from asserting a claim to the securities in dispute. But because L has no practical means of discovering claims to or the existence of the fungible bulk of securities, that argument probably would fail.
breach of trust.\textsuperscript{258} Although \(I-1\) clearly has fiduciary obligations to customers for whom it controls securities,\textsuperscript{259} it is doubtful that \(I-1\) is a trustee to which trust law principles apply.\textsuperscript{260}

Although Article 8 subjects all non-bona fide purchaser claimants to a first-in-time regime, the last-in-time good faith transferee rule in the Proposed TRADES Regulations would result in priority for \(I-2\) and \(L\) in the case of \(C-1\)’s pre-existing interests.\textsuperscript{261}

C. Observations

The emphasis on timing, whether first-in-time or last-in-time, is questionable considering that \(C-1\) has little or no way to control or find out about the transactions with \(I-2\) and \(L\), either ex ante or ex post. The same can be said for \(I-2\) and \(L\) with respect to \(I-1\)’s transactions with \(C-1\). The principal control available to these parties lies in their respective selections of intermediaries. Yet, as shown above, \(C-1\) may sometimes prevail even though its intermediary, \(I-1\), has failed and \(I-2\) and \(L\) sometimes will lose even though their respective intermediaries have not failed.\textsuperscript{262}


\textsuperscript{259} See C. Meyer, The Law of Stockbrokers and Stock Exchanges, § 40, 251-53 (1931 & Supp. 1936); see also pre-1978 § 8-313 comment 1 ("The relationship [between a broker and its customer] . . . is unique, partaking of various aspects of an agency, bailment, trust and pledge.").

\textsuperscript{260} See C. Meyer, supra note 259, § 40, at 251-52 ("Although such a [stock] broker is sometimes referred to as a trustee, he is not a trustee in the strict technical sense of the word, but a quasi trustee, of the same character as any agent to whom money or other property is entrusted by his principal for the purposes of the agency.") (footnotes omitted); 1 A. Scott & W. Fratcher, supra note 258, § 8, at 95 ("A person may be both agent of and trustee for another. . . . In such a case, however, it is the agency relationship which predominates, and the principles of agency, rather than the principles of trusts, are applicable."). Whether a securities intermediary, such as a stockbroker, is a true trustee or merely an agent who holds title to its principals’ property will turn on the particular facts and circumstances involved. See Restatement (Second) of Trusts, § 12 comment h, at 38-39 (1959); 1 A. Scott & W. Fratcher, supra, § 12.10, at 173-75.

\textsuperscript{261} The opposite result would obtain under the Proposed TRADES Regulations when \(C-1\)’s purchase followed the secured loans by \(I-2\) and \(L\). See supra notes 233-38 and accompanying text. Although the clearing lien priority may solve the most significant practical concerns, neither the Treasury Department nor those that commented on the Proposed TRADES Regulations, supra note 7, explained why, when a clearing lien is not involved, upper-tier claimants should be senior some of the time and lower-tier claimants should be senior some of the time. Concerns for clearing liens differ from concerns for other upper-tier claimants only in degree, not in character.

\textsuperscript{262} If upper-tier claimants such as \(I-2\) and \(L\) desire complete protection from claims of existing customers of \(I-1\), they could insist that the securities to be transferred to them along a route that leads upstream through the books of a clearing corporation (or the Fed, in the case of treasury securities), resulting in bona fide purchaser status. See supra notes 95, 128-32 and accompanying text. But that approach would result in additional costs and could be disruptive.
This discussion of different-tier priorities further illustrates that the property construct of the existing legal regime is subject to basic defects. As observed in the context of same-tier priorities, its application to different-tier priorities is confusing, awkward, and unprincipled. Application of the property interest construct is ill-suited to the resolution of these conflicting claims. With limited exceptions, it fails to deal expressly with the unique circumstances involved when securities are a part of fungible bulks reflected by the books of intermediaries. It relegated priority conflicts to the first-in-time principle where bona fide purchaser status is not achieved. Moreover, before appropriate resolutions of priority contests can be teased out, it is necessary to ascertain that two competing claimants are asserting rights in the same securities. But Article 8, the existing book-entry Treasury Regulations, and the proposed regulations provide no guidance as to how this can be accomplished when the securities are all a part of fungible bulks. It is troubling that codification efforts in-

of otherwise desirable market practices and relationships. Presumably the relationships of I-1 and L with I-2 and I-3 make sense to the parties. In many cases, I-2 and I-3 will perform "clearing" or "carrying" services for their respective downstream intermediary customers, but this is not necessarily the case. See generally Fitzpatrick & Carman, An Analysis of the Business and Legal Relationship Between Introducing and Carrying Brokers, 40 Bus. Law. 47 (1984). Even if I-2 and L were to insist that their security interests be transferred through a series of transfers to and by other intermediaries that involved, at some point, entries on the books or a clearing corporation, upon completion of the transfers, assuming that I-2 and L would then claim through a new and different intermediary, it then would be necessary to work through these same priority puzzles while contemplating the insolvency of the new intermediary.

For example, the Treasury Department has acknowledged the fungibility of book-entry Treasury securities and the general impossibility of tracing. November TRADES Summary, supra note 145, at 43035. Yet the operation of the good faith transferee rule under the Proposed TRADES Regulations, supra note 7, depends, in the context of conflicting claims on different tiers, on an identification of conflicting claims in the same security. C-1 would face a difficult task in asserting that the securities transferred to I-2 and L were the same ones that were (earlier or subsequently) transferred to C-1. But, assuming C-1 could offer a rational basis for tracing the securities it claims to those also claimed by I-2 and L, those parties also would find it difficult to establish that the securities they claimed were different from those claimed by C-1. For an example of the difficulty of tracing securities controlled in a fungible bulk, see Kirkwood v. Taylor, 590 F. Supp. 1375, 1377-83 (D. Minn. 1984) (plaintiffs alleging misleading registration statement in action under 15 U.S.C. § 77k(a) (originally enacted as Securities Act of 1933, § 11a) failed to meet strict tracing requirement). Under the proportionate property interest rule, however, C-1 would be in a position to claim, as against I-2 or L, a proportionate interest in the securities claimed by those parties even if C-1 could not trace the securities strictly. Cf. R. Brown, The Law of Personal Property § 36, at 80-82 (liability of transferee of wrongly confused personal property to owner of a proportionate interest in the property), § 79, at 297-98 (liability of transferee from bailee of commingled fungible goods to owner of a proportionate interest in goods); R. Powell & P. Rohan, Powell on Real Property ¶ 506, at 601-02 (One Volume Edition 1968) (one cotenant can sue as a single plaintiff, and is not required to join action in which all cotenants are parties, in order to recover property interest or damages for injury to property interest). C-1's proportionate in-


tended to bring clarity and predictability to the law have left such uncertainty in their wakes.

V. A NEW MODEL FOR RESOLVING DIFFERENT-TIER COMPETING CLAIMS AND PRIORITIES

Part IV demonstrates that applying existing property law rules to competing claims on different tiers spawns complexity, uncertainty, and disagreement as well as arbitrary and fortuitous results. The size and significance of the securities markets and the importance of these priority issues notwithstanding, current law has not been subjected to searching analysis and criticism. Part IV and this part seek to fill that void.

The SIPA/Subchapter III risk sharing distributional rule provides a model for dealing with same-tier customer claims on a basis other than a property law construct involving the tracing of property interests and principles of first-in-time (nemo dat) and last-in-time (bona fide purchase). This part explores a new model for resolving different-tier priority contests that would build on and complement the SIPA/Subchapter III approach. The potential benefits of a new model are examined here by considering a proposed priority rule for resolving different-tier priority contests involving transfers of interests in fungible bulks of securities controlled by intermediaries.

A. The Basic Principle: Upper-Tier Priority

The cornerstone of the priority rule proposed here is one overrid-
ing principle: claimants on a higher tier will always prevail over claimants on a lower tier. To state this principle of upper-tier priority (UTP) another way, the transferee of an interest in a fungible bulk of securities controlled by its intermediary can look only to its intermediary for the benefits of the securities transferred. Consequently, UTP also contemplates the adoption of a corollary rule: An intermediary on whose books an interest in a fungible bulk of securities is transferred would, as a matter of law, warrant that the transferee will receive (and will continue to receive) the benefits of the interest being transferred.265

UTP does not reject the notion that a transferee claiming through an account with a lower-tier intermediary receives a property interest. Rather, UTP deals with how interests in securities are to be allocated, as among different-tier claimants, in the event a lower-tier intermediary fails. The property available to satisfy the claims of lower-tier intermediary transferees would be limited to the securities that are not subject to competing claims through accounts with intermediaries on higher tiers.266 Application of UTP to Example 1 would resolve the priority disputes in favor of I-2 and L and against C in every instance.267

Although UTP might seem harsh, even cruel, the caveat issued in the Introduction bears repeating: it is assumed that smaller, unso-

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265 See generally infra Part V(B).
266 UTP would not, however, promote involuntary transferees, such as lien creditors, who are not purchasers, even if such claimants could be characterized as "upper-tier." See U.C.C. §§1-201(32) (defining "purchase" as a "taking by . . . [a] voluntary transaction"), 1-201(33) (defining "purchaser"), 9-301(3) (defining "lien creditor"); see also, Mazer v. Williams Bros., 461 Pa. 587, 337 A.2d 559 (1975) (lien creditor is not a "purchaser"). In Example 1, a judgment creditor of I-1 would be required to employ judicial process against I-1's intermediary, I-2, in order to reach securities controlled by I-2 for its customer, I-1. See U.C.C. § 8-317(4) (depositor's interest in securities controlled by a financial intermediary "may be reached by a creditor by legal process upon the financial intermediary on whose books the interest of the depositor appears."). In any event, judicial process on behalf of a creditor of a securities intermediary would be an extremely unlikely event. See supra note 165.
267 As a member of the Book-Entry Treasury Regulations Task Force of the Ad Hoc Committee on Uncertificated Debt Securities of the ABA Section of Business Law, which was charged with making comments on the Proposed TRADES Regulations, supra note 7, during 1986 and 1987, I was a principal proponent of a UTP rule. Katzman criticized a proposal of that task force for such a priority rule (proposed as an alternative) because it "precludes any form of first priority claim." Katzman, supra note 95, at 199. In the March TRADES Summary, supra note 39, the Department of Treasury observed that a priority rule that would always favor either upper-tier or lower-tier claimants would be "unjustifiably arbitrary." March TRADES Summary, supra note 39, at 8849. But neither Katzman or the Department of Treasury pursued the analysis. Part IV of this article demonstrates that both the first-in-time rule of current law and the last-in-time good faith transferee rule under the Proposed TRADES Regulations can produce arbitrary results. This Part explains that UTP is principled.
phisticated investors are adequately protected by SIPC coverage and private insurance. Upper-tier versus lower-tier, then, is not a contest between large and small, sophisticated and unsophisticated, rich and poor, or strong and weak.

Any priority rule, whatever doctrinal framework is chosen for implementing that rule, is a matter of loss allocation. In Example 1, the loss to be allocated resulted from the convergence of (i) the insolvency of I-1 and (ii) the insufficiency of securities available to J-1's estate to satisfy the claims of I-2 and L, on the one hand, and C-1, on the other. As a participant in the securities market, I-1 has exposed other participants to a credit risk and a risk that I-1 might misbehave. I-2 and L each chose to lend money to I-1 and to receive a transfer of (security interest in) securities to secure its loan, but neither chose I-1 to be its intermediary for purposes of controlling the securities. C-1 chose to purchase securities from (or through) I-1 and to allow I-1, as C's intermediary, to control those securities. The issue posed is which class of innocent market participants should bear the loss—the upper-tier claimants, I-2 and L, or the lower-tier claimant, C-1.

1. An Economic Analysis

An economic analysis is an appropriate beginning for consideration of UTP. Because the priority conflict arises in the securities markets, between members of two different classes of innocent prop-

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268 See supra notes 8, 171 and accompanying text.

269 This discussion assumes that upper-tier claimants such as I-2 and L acquired interests in securities without knowledge of any lower-tier adverse claim, such as that of C-1. A claimant with knowledge of existing lower-tier claims would not be "innocent." Alternatives for treatment of non-innocent upper-tier claimants under a new model are discussed infra Part V(C). For discussions of "innocent purchaser risk" in other contexts, see Carlson, Rationality, supra note 142 (priority rules for secured parties under § 9-312(5)); Weinberg, Sales Law, Economics, and the Negotiability of Goods, 9 J. Legal Stud. 569 (1980) (rights of owners and innocent purchasers of stolen goods).

270 For convenience, I refer in this part to claimants through intermediaries on a higher tier (such as I-2 and L) as "upper-tier claimants" and claimants through intermediaries (such as I-1) on a lower tier (such as C-1) as "lower-tier claimants."

property claimants that are each comprised of securities market participants, basing a priority rule on an economic analysis—with "efficiency" as the goal—seems to be an appropriate methodology that is not likely to offend other norms.

a. Some Basic Assumptions and Premises

In addition to assuming adequate protection of investors covered by SIPA and private insurance, this analysis assumes that it is necessary for the legal regime to establish priority rules to sort out conflicts among different-tier claimants. Private agreements among market participants would be costly, unlikely to occur, and impossible to conclude with each other market participant. This analysis further as-

are not likely to be sustained in any given application. For a response to some of these critiques, see R. Posner, Economic Analysis of Law 22-26 (3d ed. 1986).

272 Economists give a variety of meanings to the concept of "efficiency." See e.g., R. Cooter & T. Ulen, Law and Economics 44-45, 49-51 (1988); Posner, supra note 271, at 12-15; Carlson, Efficient, supra note 271, at 646-49; Carlson, Reforming the Efficiency Criterion: Comments on Some Recent Suggestions, 8 Cardozo L. Rev. 39 passim (1986); Coleman, Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law, 68 Cal. L. Rev. 221, passim (1980). As used here, efficiency means, with an important qualification, the so-called Kaldor-Hicks, or potential Pareto-superior, concept of efficiency: If the losses (costs) imposed on society by a particular legal rule are more than offset by the gains (benefits), the rule is efficient. See Posner, supra note 271, at 12-14; Carlson, Efficient, supra, at 647-49; Shapack, Puzzle, supra note 205, at 1070-71 & n.10. The analysis here compares only the direct costs and benefits for securities market participants that result from current law with those that would result from adopting UTP—a partial equilibrium analysis. See Posner, supra note 271, at 72-74; F. Stephen, The Economics of the Law 62-63 (1988). Although this analysis provides a useful means of identifying and exploring costs and benefits for these participants, the qualification is necessary because it does not consider external costs and benefits. For example, the effects of priority rules in other markets in other parts of the economy are not treated. Thus, I do not claim that UTP necessarily would result in an efficient result for the society as a whole.

273 Even the sharpest critics of normative economic analysis of law might concede that wealth maximization is one appropriate standard for resolving priority disputes among securities market participants, at least when the players involved are not wrongdoers. I make no claim, however, that "noneconomic" values should be ignored in fashioning legal rules merely because the interests of large, wealthy parties may be at stake. See infra notes 333-91 and accompanying text (discussing liability of upper-tier claimants that have knowledge of lower-tier adverse claims).

274 In theory, private agreements among market participants could provide an efficient resolution of priority contests. See R. Cooter & T. Ulen, supra note 272, at 105 (stating the "Positive Coase Theorem" as "when parties can bargain together and settle their disagreements by cooperation, their behavior will be efficient regardless of the underlying rules of law"). Because any such contractual solution would arise in the presence of a clear market failure, however, reliance on private bargaining would not be likely to result in an efficient outcome. The market failure springs, in part, from the structure of securities markets and the extent of trading through intermediaries, resulting in inadequacy of information available to the market participants as to who the other participants are and what securities they own. The market is likely that information available to market participants would be asymmetrical and that it is not that the asymmetry could consistently favor or distance either upper or
sumes no change in current law except as it would be changed by the UTP rule.\textsuperscript{273} Under current law, (1) lower-tier claims are subject to dilution under the SIPA/Subchapter III sharing rule or (when that scheme does not apply) the Article 8 proportionate property interest formulation, (2) an upper-tier claimant (such as I-2 or L) is senior to a lower-tier claimant (such as C-1) if the upper-tier claimant achieves bona fide purchaser status or if its interest is first-in-time,\textsuperscript{276} and (3) a lower-tier claimant, because it cannot become a bona fide purchaser where a fungible bulk is involved, is senior only when its interest is first-in-time.\textsuperscript{277} It follows that the only change in result that would arise from imposing a UTP rule would be subordination of a lower-tier claimant when an upper-tier claimant is second-in-time and does not become a bona fide purchaser.\textsuperscript{278}

\textsuperscript{273} Although one cannot plausibly argue the normative from the positive, there appears to be general satisfaction with the results of basic priority rules under current law concerning the transfer and pledge of interests in securities, except for the issues involved in moving from current law to a UTP rule. As discussed in Part IV, where fungible bulks are involved both current law (first-in-time) and the Proposed TRADES Regulations' good faith transferee rule (last-in-time) result in arbitrary and fortuitous results that cannot be predicted by transferees on any tier. A strictly applied lower-tier priority (LTP) rule, on the other hand, would have the effect of encouraging upper-tier claimants to eschew claiming an interest in a fungible bulk or to take steps to achieve (or cause their intermediaries to achieve) bona fide purchaser status, such as passing the transfers through a clearing corporation. See supra note 25. The result of LTP, then, would be UTP. Because upper-tier claimants can become bona fide purchasers, UTP often will be the result under current law as well. But achieving bona fide purchaser status may be costly for some upper-tier claimants. In the absence of persuasive arguments for moving to either a last-in-time or a LTP scheme, I am satisfied for now to examine the relative costs and benefits of current law and the proposed UTP rule.

\textsuperscript{276} See generally supra Part IV.

\textsuperscript{277} Id.

\textsuperscript{278} A lower-tier claimant could obtain such seniority under current law only if its interest in
It is assumed finally that lower-tier claimants are generally aware of the risks of dilution and subordination that could follow from the failure of their intermediary.\textsuperscript{279} If this is so, then a lower-tier claimant's selection of an intermediary demonstrates that claimant's willingness to be exposed to those risks with respect to that intermediary. Given the scope and potential magnitude of intermediary failure risks, it is unlikely that lower-tier claimants place material reliance on the limited potential, under current law, for a claim against (or a senior claim to securities also claimed by) an upper-tier transferee or secured lender.\textsuperscript{280} Because the prospect for obtaining seniority over an upper-tier claimant is likely to be ignored by a lower-tier claimant as de minimis, were UTP the law a lower-tier participant would be likely to choose the same intermediary that it has chosen under current law. Stated otherwise, a lower-tier claimant would place a low value (per-
hapless no value) on either the retention or the loss of the limited current potential for seniority.

Since lower-tier claimants likely disregard the limited potential for seniority over upper-tier claimants, and the likelihood of lower-tier seniority is necessarily identical to the likelihood of upper-tier subordination, one might think that upper-tier claimants also disregard their equally limited potential for subordination. But that is not necessarily the case. A lower-tier claimant that selects an intermediary thereby indicates its willingness to be exposed to the broad risks inherent in the intermediary’s insolvency. The fact that an upper-tier claimant has not chosen that intermediary to control its securities demonstrates its corresponding unwillingness to be exposed to the same risks. Upper-tier claimants such as I-2 and L often obtain collateral precisely in order to minimize the impact of the insolvency or misbehavior of a lower-tier firm (such as I-1). A lower-tier

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281 By posing the issue of whether to retain current law or move to the proposed UTP scheme, I have assumed that the adverse consequences for lower-tier claimants associated with intermediary insolvency under current law will remain. See supra notes 275-78 and accompanying text.

282 As a result of this choice, upper-tier claimants are not “customers” of the downstream intermediary, and under current law are not subjected to the SIP/SC/Subchapter III risk sharing formula or the Article 8 proportionate property interest formula in the event of insolvency. I do not claim that the statement in the text is invariably factually accurate with respect to every upper-tier claimant in every transaction. For example, it is possible that L, in Example 1, subjectively believed that the financial strength and integrity of I-1 was equal or superior to that of I-2. But the statement in the text is a reasonable assumption for most cases because of the general awareness of substantial risks of intermediary insolvency, the market participants’ means to “vote with their feet” by selecting intermediaries to control their securities, and the fact that a lower-tier claimant necessarily is exposed to material insolvency risks of its intermediary. The exercise here is a comparison of aggregate costs and benefits of the respective classes of upper and lower-tier claimants. It would, however, be an overstatement to assert that an upper-tier secured creditor such as I-2 or L has no credit risk arising from extending credit to the downstream intermediary, such as I-1. See Stigum, Trade, supra note 4, at 178-79 (discussing clearing bank perceptions of credit risk).

283 In Example 1, the principal purpose of the collateral transferred by I-1 to I-2 and L is to minimize the impact of I-1’s insolvency and misbehavior. Lenders to securities firms report that there are many instances when credit would not be extended except on a fully secured basis, regardless of any risk premium that could be charged for unsecured credit. Interview with James Clark, Vice President, Citibank, N.A. (June 22, 1989). Credit extended by banks that perform clearing services for government securities dealers is an extreme example. See supra notes 49, 233 and accompanying text. The debate surrounding the Proposed TRADES Regulations, supra note 7, and the insistence upon explicit protection for “clearing lien[s]” illustrates these concerns. See supra note 233 and accompanying text; see also Kripke, supra note 205, at 941 (“[I]n most situations involving secured credit, the credit could not have been obtained without granting security.”) I do not embrace the whole of Kripke’s rather thorough “trash” of the commercial law-related law and economics literature. See Jackson & Schwartz, supra note 205. However, assuming, as I do, that the law will continue to preserve secured claims that are generally protected in bankruptcy and against third parties, Kripke’s statement seems to apply to secured credit extended in the securities markets. For a persuasive
claimant who has willingly exposed itself to the risks of its intermediary’s insolvency, then, absorbs the risk of the insolvency of that intermediary better than an upper-tier claimant. 284

The implications of the foregoing for the proposed UTP rule can be evaluated in light of three conventional models for considering the efficiency of legal rules that allocate losses. 285

b. Lower Cost of Reducing or Avoiding Loss

In economic terms, efficiency of the market could be enhanced by adopting a priority rule that assigns the loss to the class of participants that could avoid or reduce the losses at the lower cost. 286 For example, assume T steals goods from O and then sells the goods to P. As between the two innocent parties, O and P, the efficient rule would allocate the loss to the party that could have avoided the loss at the lower cost. 287 If O’s costs of protecting the goods from theft are
lower, the loss should fall on $O$. If $P$'s costs of investigating $T$'s source of title are lower, the loss should fall on $P$. If $I-1$, in Example 1, is characterized as the thief, the question is whether $C-1$'s costs of avoiding the loss (viewing $C-1$ as the first-in-time $O$) or those of $I-2$ or $L$ (each a second-in-time $P$) are lower.\(^{288}\)

Because $I-2$ and $L$ have no practical means of determining that the securities involved are free of claims of $I-1$'s customers (such as $C-1$), they must choose among (i) eschewing the transactions with $I-1$, (ii) charging $I-1$ a higher interest rate (risk premium), and (iii) incurring (and passing on to $I-1$) the costs of becoming bona fide purchasers so as to cut off $C-1$'s rights. Each of these choices is likely to involve material costs.\(^{289}\) $C-1$ also lacks any practical means of protecting its interest against $I-1$'s wrongful transfers once $C-1$ has elected to allow $I-1$ to control its securities in fungible bulk. But, ex ante, $C-1$ has a near costless choice: $C-1$ can select another intermediary.\(^{290}\) Because $C-1$'s marginal costs of avoiding the risks of losses

\(^{288}\) The theft scenario is distinguishable because $C-1$, in Example 1, chose to allow $I-1$ to control $C-1$'s securities. In the theft example just mentioned, $O$ did not voluntarily allow $T$ to control the goods. It is also distinguishable as to the likely effect of the priority rule on the behavior of $I-1$. Posner argues that allowing a purchaser from a thief to cut off a real owner's rights would encourage theft. Posner, supra note 271, at 71. Because an upper-tier securities claimant could achieve such priority by becoming a bona fide purchaser, whether or not UTP were adopted, it is doubtful that UTP would encourage intermediaries such as $I-1$ to misbehave by wrongfully transferring customer securities.

\(^{289}\) In addition to the obvious costs of refusing to do business, imposing additional risk premiums, and achieving bona fide purchaser status (such as by "laundering" securities though a clearing corporation), efficiencies and cost savings may arise from the relations between the parties. For example, $I-2$ may be acting as a carrying or clearing firm for $I-1$. See supra note 262. It would disrupt the basis of the relationship between $I-2$ and $I-1$ were yet another intermediary to become involved in a secured loan from $I-2$ to $I-1$.

\(^{290}\) It is not suggested that either selecting an intermediary or continued monitoring is costless. Rather, it is assumed that a lower-tier claimant's costs (such as investigation and consideration of reputation, financial condition, etc.) are sunk costs that have already been expended by the lower-tier claimant when it selected its intermediary and assumed the risks flowing from that selection. Ongoing costs of monitoring can also be characterized as sunk costs for this analysis because it is assumed that the lower-tier claimant is going to select an intermediary in any event, and any ongoing costs would be incurred in the face of risks imposed under current law, whether or not UTP were in place. The statement in the text also assumes the existence of readily available substitutes for $J-1$. Such substitutes appear to be
occasioned by J-1’s insolvency—by choosing another intermediary—are less than the corresponding costs of J-2 and L, moving from current law to UTP would enhance efficiency.291

Here is another way to compare upper- and lower-tier claimant costs of loss reduction were current law to change to UTP: Under current law, there are no means for a lower-tier claimant to achieve protection from the risk of substantial loss upon its intermediary’s failure, short of choosing another intermediary.292 Also under current law, an upper-tier claimant can achieve seniority over earlier-in-time lower-tier claims by becoming a bona fide purchaser. Consequently, moving from current law to UTP would leave lower-tier claims with essentially unchanged prospects—substantial risk of subordination. And UTP would enable upper-tier claimants to achieve seniority without incurring costs of becoming bona fide purchasers.

It appears that the single, most powerful, control that a market participant can employ to reduce intermediary risk is to exercise precaution by selecting an intermediary that will not fail.293 A UTP rule

available in the United States markets today, given the large number of securities firms and banks.

291 Because a change in law can enrich the beneficiaries of the change (here, upper-tier claimants) and “poor” the losers (here, lower-tier claimants), the “wealth effects” of the change can affect the demand of both losers and winners. The results can be affected by the assumption as to who initially possesses the wealth that a proposed legal rule would seek to change. In an extreme case, a new legal rule that redistributes wealth would create a new world where it would be efficient to reinstate the old rule. See Carlson, Efficient, supra note 271, at 649-51 (citing Scitovsky, A Note on Welfare Propositions in Economics, 9 Rev. Econ. Stud. 77 (1941); Kennedy, supra note 271). “This never-ending modulation between two efficient universes is called the ‘Scitovsky Paradox.’” Carlson, Efficient, supra note 271 at 650.

It is a plausible assumption that the wealth effects of a move from current law to UTP would be minimal or non-existent. Because lower-tier claimants value the potential for seniority to upper-tier claimants at zero or near-zero, UTP would reflect the existing expectations of lower-tier claimants. As for upper-tier claimants, the actual subordination of upper-tier claimants to lower-tier claimants under current law is an infrequent occurrence. It is unlikely that the demand of either class of claimants would be affected materially. Nevertheless, questioning the efficiency of moving from current law to the new model gives the benefit of any doubt to current law. Id., at 650-51 & n.30.

292 See supra note 281.

293 Cooter and Rubin articulated “four distinct elements of the [loss reduction] principle’s operation: precaution, innovation, responsiveness, and learning.” Cooter & Rubin, supra note 271, at 73. The process of selecting an intermediary is the most direct means of exercising precaution. Given the assumption that unsophisticated claimants are adequately protected by SIPIC and private insurance, it is reasonable to assume that no significant differences exist among other claimants—whether upper- or lower-tier—in their abilities or propensities to learn or respond to risks imposed by legal rules. Although all market participants could avoid relationships with intermediaries that would expose their interests to risks should those intermediaries fail, participants must involve and employ securities intermediaries in order to participate in the market and, in theory, any such intermediary could fail. Innovation is discussed infra text accompanying notes 305-69. Evidence of current market behavior indicates that market participants who are not fully protected by SIPIC and private insurance are highly
would place the risk of loss on C-1, the party that chose I-1 as its intermediary, and would promote I-2 and L in every case because they did not choose I-1 as their intermediary to control the securities. But UTP would not mean that, in Example 1, C-1 would be forced to choose between refusing to do business with I-1 or being exposed to I-1’s credit and integrity risks. C-1 could have purchased securities from or through I-1 while choosing another intermediary to control the securities in order to avoid such exposure.294

Three other means of reducing or avoiding loss ought to be mentioned, but none is contrary to the notion that lower-tier claimants are the lower-cost loss avoiders. One means is to make it more likely that such intermediaries do not fail. The regulatory approach is directed to this end.295 It is doubtful that either upper-tier or lower-tier claimants are positioned to assert a material influence on the failure or survival of a securities intermediary through direct supervision.296 However, to the extent that market participants are more or less likely to select a securities intermediary based on their assessments of its creditworthiness and integrity, and regulatory compliance market discipline might discourage intermediaries from engaging in risky activities or misbehavior.297 The selection or rejection of an intermediary is, again, central. As among claimants against a given intermediary,
under both current law and UTP the risk is greatest for lower-tier claimants who allow the intermediary to control their securities. These claimants, then, may be the more accurate, thoughtful, and effective disciplinarians. But even if upper-tier claimants are better monitors, for some of those claimants achieving bona fide purchaser status may be less costly and more reliable than monitoring.

A second possible means of reducing or avoiding losses attributable to intermediary failures is to make it more likely that when intermediaries do fail there will be sufficient securities available to satisfy all claims, both upper- and lower-tier. It is doubtful that either upper-tier or lower-tier claimants can monitor effectively the relationship between securities claimed through intermediaries and the securities available to satisfy those claims. Establishing and complying with a system of public notice for claims to interests in fungible bulks of securities controlled by intermediaries would involve

298 Intermediaries not often chosen by lower-tier claimants (except those who are fully protected by SIPC) may be exposed to little monitoring from any quarter except that imposed by regulatory requirements. For example, it is unlikely that small securities firms would be chosen to control portfolios of large investors regardless of the strength of market discipline. Lower-tier claimants may impose market discipline by rejecting certain intermediaries rather than by monitoring intermediaries with whom they have a relationship. In the absence of material unsecured creditors, such intermediaries are exposed to the "moral hazard" problem that is exacerbated by SIPC protection; only regulatory restraints are available to discourage risky, opportunistic behavior. It does not follow, however, that efficiency concerns dictate that upper-tier claimants be exposed to risks of subordination to lower-tier claimants. Lower-tier claimants are not attracted to weaker intermediaries merely because of the limited potential for a windfall claim against an upper-tier claimant. And, under current law, upper-tier transferees of, and secured lenders to, such intermediaries (who, by hypothesis, are not willing to be exposed to insolvency risks of a lower-tier intermediary who they would not choose to control their securities) might be driven away or might charge a higher risk premium. More plausibly, in many cases the upper-tier claimants might be forced to incur costs of ensuring that they achieve bona fide purchaser status.

299 Stated otherwise, lingering subordination risks for upper-tier claimants do not necessarily result in effective monitoring when there is a less costly way to obtain protection. Moreover, as between current law (bona fide purchaser protection) and UTP, UTP would result in even greater cost savings.

300 Again, this is an important goal of the regulatory approach.

301 In Example 1, I-2 and L have no feasible means of finding out about C-1's claims, whether the transfer from I-1 to C-1 occurs before or after the transfers to I-2 and L. The same can be said for C-1 as to the claims of I-2 and L. See supra note 110. This is in contrast to the ease of transfers of interests in discrete goods. A prospective transferee of discrete goods can reduce the "innocent purchaser risk" by investigating the source of its transferee's title. See, e.g., Mooney, supra note 124, at 749-51; Weinberg, supra note 269, at 584. Similarly, an owner of goods can take precautions to reduce the risk of loss or theft. See, e.g., R. Cooter & T. Ulen, supra note 272, at 153-54; Weinberg, supra note 269, at 584. The public notice provisions of Article 9 also provide a means for a secured party to obtain protection against subsequent claims against goods collateral and for a prospective purchaser to discover that a security interest may exist. U.C.C. §§ 9-302, 9-402.
enormous costs and would almost certainly be impracticable.\textsuperscript{302} Nor can lower-tier transferees effectively protect against subsequent transfers to other transferees, some of whom may become bona fide purchasers.\textsuperscript{303} Even if either upper-tier claimants or lower-tier claimants could avoid or reduce loss at a lower cost by ascertaining the status of conflicting claims to, and policing, the securities they claim, it is likely that the costs would swamp the benefits.\textsuperscript{304}

The third means of reducing or avoiding loss is less obvious. Allocating losses to the class of claimants that can best cause loss reducing innovation in the marketplace might provide a more efficient means of loss reduction than would allocating losses on the assumption that market structure and practices will remain more or less static.\textsuperscript{305} But the potential for loss reduction through innovation is enormously difficult to assess. By definition, we cannot know specifically what the innovation would address, what techniques would be involved or whether any material degree of success could be achieved.\textsuperscript{306} Even if innovation considerations were to favor allocating loss to upper-tier claimants, the benefits of that allocation might be insufficient to offset the other lower-cost loss avoidance factors.\textsuperscript{307}

\textsuperscript{302} See supra note 142.

\textsuperscript{303} See supra notes 90-91 and accompanying text.

\textsuperscript{304} Certain upper-tier claimants, such as carrying or clearing brokers for other (downstream) intermediaries, may have an information advantage over lower-tier claimants who are customers of the carrying or clearing broker’s downstream intermediary-customer. The carrying or clearing broker is likely to have access to information concerning the customers of its customer. See Fitzpatrick & Carman, supra note 262, at 53-54. But the carrying or clearing broker’s costs of verifying the absence of lower-tier customer claims probably would be prohibitively high. Carrying and clearing firms are subagents of their downstream intermediary-customers who are, in turn, agents of their downstream customers. See id. at 63-64. Imposing on the carrying or clearing firm the risk of wrongful instructions by its principal, with the associated costs of verifying such instructions with the customers of its principal, could offset the efficiencies sought to be obtained by carrying and clearing arrangements.

\textsuperscript{305} See Cooter & Rubin, supra note 271, at 77-78. For example, the check hold limitations imposed by the Expedited Funds Availability Act and Regulation CC issued thereunder were, in part, intended to provide an innovation incentive for banks to shorten the period for check collections and returns. See Expedited Funds Availability Act, 12 U.S.C. §§ 4001-10 (1988); 12 C.F.R. pt. 229 (1990); Cooter & Rubin, Orders and Incentives as Regulatory Methods: The Expedited Funds Availability Act of 1987, 35 UCLA L. Rev. 1115, 1157, 1164-67 (1988).

\textsuperscript{306} If we knew the answers to these questions then the steps to be taken would not constitute innovation.

\textsuperscript{307} Assume that C-1 (in Example I) is an institutional investor such as an insurance company, investment company, mutual fund, or pension fund. Further assume that I-2 and L are securities firms, banks or other securities professionals. Arguably the securities professionals would be better positioned than the institutional investors to influence innovation in the securities markets. But, if it is correct that the lower-tier claimants are otherwise the lower-cost loss avoiders, it would not be efficient to assign loss to upper-tier claimants unless innovation considerations were sufficient to offset the other lower-cost loss avoidance factors. In general, this would not seem to be the case (but one could never know for sure). If the goal of the loss
Moreover, most securities professionals sometimes are upper-tier claimants and sometimes are lower-tier claimants. Because securities professionals sometimes are lower-tier claimants, and because of warranties made by intermediaries to their customers, substantial and adequate inducement for innovation may already exist.

To sum up: the issue posed is whether to move from current law to UTP. The costs of achieving bona fide purchaser status imposed on upper-tier claimants, under current law, are likely to be less than the costs of either monitoring or innovation. If this is so, then upper-tier transferees from intermediaries, who do not wish to allow those intermediaries to control the securities, are more likely to choose to achieve seniority over earlier-in-time lower-tier claimants by becoming bona fide purchasers than to opt for uncertain protection from monitoring and innovation. Thus, even assuming that upper-tier claimants would be better (lower cost) monitors of intermediary solvency, better monitors of the availability of securities to satisfy securities claims against intermediaries, and better innovators, consideration of these three additional means of loss reduction does not alter the initial conclusion that lower-tier claimants seem to be the lower-cost loss avoiders.

308 See generally infra Part V(B).

309 The last twenty years have seen widespread innovation resulting from enormous efforts by the securities industry and regulators to reduce risk and enhance efficiency in securities trading, clearing, and settlement. See, e.g., supra notes 23-38 and accompanying text (development and operation of DTC-NSCC clearing and settlement system); supra note 39 (new PTC system for clearing and settlement of Ginnie Mae transactions); supra note 49 (new GSCC system for netting in clearing and settlement of government securities trades); supra notes 8, 171 and accompanying text (SIPC protection for customers of registered broker-dealers); DTC 1989 Report, supra note 23, at 22-34 (expansion of eligible issues by 19% during 1989 Same-Day Funds Settlement System, municipal bond program, “book-entry only” securities, Institutional Delivery System, automation of depository system, domestic and international interfaces among clearing organizations); G-30 Report, supra note 11 (recommendations for clearance and settlement practices and standards for major world securities markets).
c. Loss Spreading and Risk Bearing

The efficiency of a loss allocation rule also may be evaluated in terms of the principle of loss spreading. If, as a result of loss spreading, lower-tier claimants can bear losses resulting from intermediary risk at a lower cost than upper-tier claimants, the latter would be willing to pay the former to assume such losses and assigning losses to lower-tier claimants would promote efficiency. 310 Loss spreading will be most effective when the party to whom losses are allocated can spread the losses among a large number of transactions or relationships, when the expected losses are small in comparison to that party's capital, and when the occurrence of the losses are sufficiently frequent so as to be predictable. 311

At first blush, upper-tier claimants might seem to be more effective loss spreaders because they can be expected to have many securities intermediaries as customers or borrowers while lower-tier claimants normally select only a few intermediaries to control their securities. 312 But losses arising from an intermediary insolvency do not fit the loss spreading paradigm—they are potentially quite large and the occurrence is relatively infrequent and unpredictable. Allocating such losses either to upper-tier or lower-tier claimants based on a loss spreading rationale would be of doubtful wisdom. 313 Although SIPC protection for smaller claims is a means of spreading customer

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310 See, e.g., Cooter & Rubin, supra note 271, at 71 (“Whenever one person can bear risk at a lower cost than another, there is an opportunity for a mutually beneficial exchange, because risk averse people will pay risk neutral people to assume the risk of loss.”); see also H. Denenberg, R. Eilers, J. Melone, & R. Zelten, Risk and Insurance 3-29 (2d ed. 1974) [hereinafter Denenberg]. It is not contemplated here that either lower-tier or upper-tier claimants would actually pay members of the other class. Rather, the question posed reflects a technique of exploring whether one class or the other could better bear the loss.

311 See Cooter & Rubin, supra note 271, at 71. Loss spreading, or “pooling,” is the basic economic principle that underlies insurance. See Denenberg, supra note 310, at 10, 12-14.

312 See supra note 57 and accompanying text.

313 When the failed intermediary is a securities firm, under SIPA and the Bankruptcy Code the risk sharing formulation for claimants on the same tier is a form of loss spreading. See supra Part III. Would expanding that formulation to upper-tier claimants, including secured creditors such as F-2 and L (in Example 1) have merit as a method of loss spreading? Under that formulation, losses would be spread among upper- and lower-tier claimants rather than allocated to one class or the other. See supra notes 243-246 and accompanying text (discussing and rejecting a similar interpretation of the U.C.C. § 9-313(2) proportionate property interest rule). That approach also would not be likely to enhance efficiency. Although it would be more beneficial to upper-tier claimants than subordinating their claims to lower-tier claims or reducing them to unsecured status, the losses would remain potentially quite large and unpredictable. This risk sharing approach may be sound when applied on the same tier, and it might be wise to extend it to non-securities firm intermediaries such as banks, but it is doubtful that it would provide much comfort (i.e., reduction of risk aversion) either to lower-tier claimants or to upper-tier claimants, viewed ex ante.
losses among all SIPC members, expanding SIPC coverage to larger claims also would be problematic. That approach could promote a “moral hazard” problem and reduce the level of care exercised by market participants in their selections of intermediaries.

Loss spreading aside, the following analysis suggests that lower-tier claimants can better bear credit risks of their securities intermediaries. Keep in mind that the issue posed here is the efficiency of moving from current law to UTP. Because, under current law, lower-tier claimants are already subject to substantial intermediary credit risk, are likely to disregard any potential for seniority, and would likely disregard any potential for subordination under UTP, UTP would not materially affect their perceptions of that risk. And because C-1 would disregard the risk of subordination to a later-in-time non-bona fide purchaser were UTP the rule, C-1 would not choose another intermediary merely to avoid that subordination risk. Conversely, because of the other risks of loss and subordination

314 The ultimate source of the SIPC fund is assessments against SIPC members—essentially all registered broker-dealers. See supra note 70. The imposed sharing, among participants, of losses arising out of defaults in the clearing and settlement process is another example of risk-sharing. See supra note 32.

315 See supra notes 298-99. A strict lower-tier priority rule could have the same effect were it not for the ability of upper-tier claimants to achieve bona fide purchaser status. See supra note 275. Perhaps a moral hazard problem already exists under current law for certain securities intermediaries. See supra note 298. If so, it derives from the combined circumstances that current law awards seniority to upper-tier transferees, including secured creditors, who achieve bona fide purchase status, and SIPA provides protection for qualifying customer claims. As already explained, the impact on lower-tier claimants, were seniority extended under UTP, would be minimal. See supra notes 275-84 and accompanying text. UTP’s expanded subordination of lower-tier claims would, to the extent such claims are covered by SIPC, place corresponding additional burdens on SIPC that, for the same reasons, would also be viewed as minimal. Whether a moral hazard problem resulting from inadequate private monitoring raises a broader concern that the recent bank and thrift insolvency debacle could be repeated for securities firms is beyond the scope of this article. See supra note 297 and accompanying text. But, experience to date suggests that regulation and supervision of securities firms generally has been effective. See supra notes 55, 65-68 and accompanying text. The willingness of regulators to allow the private liquidation of Drexel, Burnham and Lambert, Inc., arising out of the chapter 11 filing by its parent corporation, suggests that de facto insurance by the federal government (taxpayers) of all creditors and customers of important securities firms is not now a reality. See supra note 13 and accompanying text.

316 See supra notes 279-84 and accompanying text. This observation also supports the proposition that loss spreading is not appropriate in this context because only upper-tier claimants are risk sensitive as to a change from current law to UTP. Again, I need not claim that a lower-tier claimant such as C-1 necessarily (or even probably) would become aware of any deterioration of J-1’s financial condition. C-1 might be quite surprised at J-1’s failure. Indeed, J-1 itself might be surprised! The point, here, is that C-1 bears the substantial risks of J-1’s failure anyway under current law as a result of selecting J-1, and moving to UTP would not materially increase those risks. Were J-2 and L aware of J-1’s deterioration, they could take steps to become bona fide purchasers under current law, but C-1 would be no better off and J-1’s financing costs would increase.
inherent in the selection of an intermediary, C-1 presumably would have selected another intermediary were it concerned about J-1’s integrity or solvency.\textsuperscript{317} Allocation of subordination risk to I-2 and L under current law imposes costs on them that they perceive as greater than the costs that C-1 would perceive to be imposed on it were such risks allocated to it. It follows that upper-tier claimants such as I-2 and L would, in theory, be willing to pay lower-tier claimants, such as C-1, in exchange for a move from current law to UTP, an amount that would be readily accepted by lower-tier claimants. Moving from current law to UTP would, then, enhance efficiency.\textsuperscript{318} Under UTP lower-tier claimants would assume the negligible additional risk only as to their chosen intermediary, while the insolvency and misbehavior risks imposed on upper-tier claimants would be reduced as to many more market participants in many more transactions.\textsuperscript{319}

d. Costs of Predicting and Imposing Loss Allocation

From the perspective of the set of market participants addressed in this analysis, legal rules that reduce enforcement costs promote efficiency for these participants.\textsuperscript{320} Loss allocation rules that are definite, clear, and simple impose lower costs than rules that are uncertain, unclear and complex.\textsuperscript{321} It is difficult to imagine a priority rule more definite, clear, and simple than UTP.\textsuperscript{322} But a strict lower-tier priority (LTP) rule would be equally clear. Although certainty of meaning and application alone may promote efficiency, that tells us nothing about the merits of the proposed UTP rule.

A simple, lower-cost loss allocation rule sometimes may even hinder efficiency. For example, if a rule were to impose the loss on

\textsuperscript{317} Given the inherent risks of intermediary insolvency or misbehavior, it is desirable for market participants to avoid selecting risky intermediaries to control their securities.

\textsuperscript{318} Again, the Kaldor-Hicks notion of efficiency does not contemplate that I-2 and L would actually pay C-1. See supra note 272. It is sufficient that the benefits to upper-tier claimants exceed the costs imposed on lower-tier claimants.

\textsuperscript{319} See supra note 57.

\textsuperscript{320} See Cooter & Rubin, supra note 271, at 78:
One feature that...[enforcement] mechanisms share is that they are costly,...
To achieve efficiency...the enforcement process should be as inexpensive as possible.

The most inexpensive approach to loss imposition would be to allow the losses to fall where they may.

In a priority contest, however, it is impossible to let the loss “fall where [it] may.” The loss does not “fall” anywhere except as the allocation is directed by a priority rule as interpreted and applied by a court.

\textsuperscript{321} See id.

\textsuperscript{322} Issues present under current law, such as timing of transfers, tracing of interests in securities, denomination of accounts with intermediaries, and the like disappear when the new model is substituted for current law. See generally supra Part IV.
the higher-cost loss avoider or on the party that is the least able to spread or otherwise bear losses, the overall effect could be less efficient. Because UTP appears to be the more efficient rule based on consideration of other factors, the lower costs of imposing the loss allocation, when compared with costs of a property law construct, could further enhance the efficiency of UTP. It is probable that any priority rule for fungible bulks of securities that follows a property law construct would involve substantial complexity and uncertainty. One might continue to explicate with layers of rules and exceptions, hoping that all of the possible scenarios would be covered, but one could never be sure that something had not been missed. Existing and proposed rules that purport to apply traditional property law doctrine in this context appear to fit this hypothesis in every case. Although in theory the traditional approach could produce simplicity and certainty, it has not done so and I see no prospects on the horizon.

A more successful model for loss allocation could reduce costs for securities market participants in circumstances other than the infrequent ex post resolution of disputes and the enforcement of rights. The most significant effect of a more clear and definite priority rule could be the resulting certainty and predictability, ex ante, necessary

323 See Cooter & Rubin, supra note 271, at 84 (“When the principles converge, the best rule is obvious, but when they diverge, their relative economic effects must be compared to determine which legal rule minimizes their combined effect.”) (footnote omitted).

324 For example, an attempt to achieve the result of UTP could follow a property law construct. The priority rule, to be applied inside and outside of insolvency proceedings, might provide that transfers of interests in securities to lower-tier claimants will always be subject to interests of upper-tier claimants and that transfers to upper-tier claimants will always be free of (or senior to) interests of lower-tier claimants. This is the approach taken by the Proposed TRADES Regulations, supra note 7, in the limited context of “clearing lien priority.” See supra note 233. If UTP produces the more efficient outcome, then such a priority rule would be an improvement over current law. But, the costs of imposing and applying that rule might remain relatively high. If, at the times transfers were made to the upper-tier and lower-tier claimants, there were sufficient securities controlled by the intermediary to satisfy all claims, that priority rule would not resolve the dispute. It would be necessary to determine, also, whether securities that were transferred to bona fide purchasers prior to the intermediary’s insolvency, and securities that remain, were the securities previously transferred to the upper-tier claimants or those transferred to the lower-tier claimants. Some sort of tracing system would be necessary.

325 Layers of explication do not necessarily add to clarity, much less simplicity. See Manning, Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 383, 36 Tax Law. 9, 11 (1982):

Elaboration in drafting does not result in reduced ambiguity. ... In physics, we are all familiar with the Law of Conservation of Energy; in law, there is an analogous Law of Conservation of Ambiguity.

326 See generally supra Part IV (discussing different-tier priorities under pre-1978 and 1978 Article 8, existing Book-Entry Treasury Regulations, and Proposed TRADES Regulations).
for market participants to reduce costs and adjust their transactions and relationships accordingly.\textsuperscript{327} In this respect, ex ante, UTP would provide much greater certainty than an LTP rule. Because it is impossible to discover the status of potentially conflicting claims to fungible bulks of securities controlled by tiers of intermediaries on a real time basis, the only fact that a market participant can be sure of is the identity of the intermediary it selects to control securities on its behalf. But, under an LTP regime, an upper-tier intermediary, such as I-2 (in Example 1), could not safely warrant good “title” to its customer, such as L,\textsuperscript{328} because I-2 could not, ex ante, determine the status of the lower-tier claims of I-1’s customers.\textsuperscript{329} Under UTP, an intermediary, such as I-2, could extend broad warranties to its customers by exercising care in the selection of its own intermediary, such as I-3, who it selects to control securities on its behalf.

e. Observations

The claim that moving from current law to UTP would lower costs for market participants and thereby promote efficiency (for those participants) seems to be supported by reasonable assumptions. But, as with many economic analyses of law, the absence of compelling empirical data and the simplicity of manageable models means that this claim must remain uncertain. Yet lawmakers, unlike scholars, must act based on available evidence, while recognizing that inaction is itself an equally profound decision to leave the law as it is. Rejection of UTP because, like any priority rule, its wisdom is inherently uncertain would be paralyzing. It would defer to existing law by default. Additionally, it would miss the point that there is little to commend the arbitrary and fortuitous results achieved under the current property law construct that sometimes favors lower-tier claimants and sometimes favors upper-tier claimants.

2. Analogues and Comparisons Under Current Law and Doctrine

The proposed UTP rule would not seek to trace property rights

\textsuperscript{327} Many lawyers have pointed out to me that the process of preparing and negotiating legal opinions dealing with transfer and pledge of securities is very time consuming, expensive, and unsatisfying to them and their clients. Presumably market participants would welcome reductions of these costs. I will leave to others the argument that putting lawyers out of work could have adverse consequences for society as a whole.

\textsuperscript{328} A broad intermediary warranty would be an essential component of a UTP priority scheme. See infra Part V(B).

\textsuperscript{329} In making such a warranty in an LTP scheme I-2 would bear the solvency/integrity risks as to every one of its customers who are also securities intermediaries for lower-tier claimants.
and sort out conflicting claims based on property law doctrine such as tracing, first-in-time, and bona fide purchase. Instead, it treads the route of the risk sharing formula that is the fundamental loss allocation principle among same-tier customers of an insolvent securities firm. Moreover, the result of a UTP rule is consistent in many respects with results under current doctrine in other contexts.

a. Negotiability and Bona Fide Purchase

UTP would leave intact the current rule that a transferee of an interest in a fungible bulk through an intermediary cannot achieve bona fide purchaser status.\(^\text{330}\) It would change current law by modifying the baseline priority rule of first-in-time that applies as among non-bona fide purchasers.\(^\text{331}\)

The essence of negotiability is that a transferee of a negotiable instrument can acquire it free of competing claims of ownership.\(^\text{332}\) The conventional wisdom is that the attributes of negotiability are essential to the market.\(^\text{333}\) Even a critic of the broad application of the negotiability doctrine in Article 3 acknowledges that negotiability is useful in a market where instruments, such as securities, are ac-
tively traded. Article 8 experts have proclaimed that negotiability is a central, even essential, element of a legal regime dealing with transfers of securities. But, if negotiability is so crucial to the market's operation, why do a large number of high-volume, high-value market participants forego bona fide purchaser status?

There are at least two good answers to this question. First, the structure and operation of modern securities markets is incompatible with the notion that transferees will routinely become bona fide purchasers. Second, even if many important market participants do not routinely achieve bona fide purchaser status, it may be important that some securities intermediaries can become bona fide purchasers.

334 See Rosenthal, supra note 333, at 398 & n.97 ("[T]here appears to be a strong commercial need to continue the protection of the good faith purchaser . . . of investment securities. . . . [which] are expected to be transferred with some frequency.") (emphasis in original); see also Gilmore, Formalism, supra note 333, at 454 ("[T]he law of negotiable instruments reflects the market; if instruments, whatever their form, do not circulate in a market, the negotiability idea becomes irrelevant.").

335 See, Aarne, Haydock & Scott, supra note 5, at 895-96 (observing, in response to the question posed by Rosenthal, supra note 333, that "just about everybody that deals in securities" needs negotiability).

336 Aside from the securities firms and banks that participate directly in a depository-clearing system, and DIs with book-entry treasury securities accounts at the Fed, it is the norm for important market participants not to become bona fide purchasers. See generally supra Part I.

337 A third answer is that negotiability is not crucial to the operation of the securities markets. See Rogers, Negotiability as a System of Title Recognition, 48 Ohio St. L.J. 197 (1987) [hereinafter Rogers, Title Recognition]; see also Rogers, Irrelevance, supra note 15. Rogers argues that negotiability does not operate as a title recognition system for Article 3 instruments drawn or made to order or for Article 8 certificated securities in registered form, primarily because the existence of a forged indorsement on such paper prevents a transferee from becoming a holder in due course or a bona fide purchaser. Rogers, Title Recognition, supra note 15, at 211-14. In the case of registered securities, Rogers explains that the risk of prior ownership claims are solved not by the bona fide purchase rule but by re-registrations of securities on the issuers' books, thereby allowing the transferee to take free of any claim of unauthorized indorsement. Id. at 214-15 & n.72; see U.C.C. § 8-311(a); pre-1978 § 8-311(a). Consistent with Rogers' thesis, DTC routinely reregisters deposited securities in its nominee's name. See DTC 1989 Report, supra note 23, at 22, 35 ("Registration of securities deposited in DTC's Cede & Co. nominee name enables the depository to: Promptly determine whether certificates are transferable or whether replacement securities should be required from the depositing Participant . . . . On receipt of registered certificates, quick transfer into DTC's nominee name, Cede & Co., allows for prompt validation of certificates."). Issuers normally protect themselves against liability to prior owners by obtaining signature guarantees covering all indorsements. See Rogers, Title Recognition, supra, at 214 n.72; U.C.C. § 8-312(1); pre-1978 § 8-312(1). Rogers fails to confront the fact that payment settlement for securities trades normally occurs at or prior to the time of delivery, not at the time of a successful reregistration. However, his argument can be saved because a transferee who is unsuccessful in an attempt to reregister because of an unauthorized indorsement also can rely on a signature guarantee. That the system rests on unsecured obligations of banks issuing signature guarantees further supports the de-emphasis of property rules and underscores the crucial role of financial institution credit in the securities markets.

338 See supra notes 23-31, 50-95 and accompanying text.
by taking physical deliveries or through book entries on the books of a clearing corporation.

Transfers on the books of a clearing corporation provide the strongest analogic support for UTP. Although these transfers can confer bona fide purchaser status, they seem to be equally as deviant from the paradigm of physical delivery of a negotiable instrument as other transfers of interests in a fungible bulk effected on the books of an intermediary. Because securities transferred on the books of a clearing corporation generally consist of a fungible bulk controlled by the clearing corporation, the interest of a transferee would be subject to the proportionate property interest rule of section 8-313(2). Nevertheless, clearing corporations generally are not perceived to impose credit and misbehavior risks on market participants as great as those imposed by other securities intermediaries.

Conceptual distinctions and similarities aside, conferring bona fide purchaser status on clearing corporation participant-transferees seems to provide benefits to the marketplace. Not only does the bona fide purchaser transferee take free of adverse claims of other participants in the clearing corporation, but it takes free of all adverse claims of all lower-tier claimants in the chain below the transferor. The quality of the interest received by downstream customers of a clearing

339 See U.C.C. §§ 8-313(1)(g), 8-320; pre-1978 §§ 8-313(1)(e), 8-320; supra note 95.
340 See U.C.C. § 8-313(1)(d)(i)(ii)-(iii). The transfer of an interest in a fungible bulk of securities through, and on the books of, an intermediary (including a clearing corporation) bears little resemblance to the physical delivery of a specific certificated security to a transferee that becomes a bona fide purchaser. The transferee on an intermediary's books sees nothing but the intermediary's confirmation, and even a confirmation is not required in the case of clearing corporation book-entry transfers. U.C.C. § 8-313(1)(g); pre-1978 § 8-313(1)(e). A fungible bulk of securities is the antithesis of a discrete certificate, and the transferee lacks any meaningful method of ascertaining the existence or size of the fungible bulk and the other claims that may be asserted to or against it. Because a clearing corporation normally has physical control of securities registered in its nominee's name, the transferee cannot effectively prevent the clearing corporation from later transferring superior rights to a third person. And, the transferee must be concerned with the creditworthiness and integrity of the clearing corporation. See generally supra Part III.
341 See U.C.C. §§ 8-313(2) (second sentence) (proportionate property interest of claimant to a fungible bulk), 8-313(4) (clearing corporation is a financial intermediary); pre-1978 § 8-313(2) (second sentence); supra notes 97-100 and accompanying text. Note that because DTC is a banking corporation (a New York limited purpose trust company) and is not a registered broker-dealer, neither SIPA nor Subchapter III would impose the risk sharing formulation on customer property were DTC to fail. See supra notes 170, 199-200.
342 No doubt that perception stems from the regulated nature of clearing corporations, their ownership, and the fact that they do not trade in securities for their own account. See U.C.C. § 8-102(3) (defining clearing corporation); pre-1978 § 8-102(3) (same); see also Aronstein, Haydock & Scott, supra note 5, at 909 (“To suggest that a clearing corporation would intentionally permit a participant or anyone else to acquire the power to transfer its securities flies in the face of reality.”).
corporation participant-transferee, and other lower-tier claimants in the downstream chain from that transferee, are indirectly enhanced by the cleansing effect of a clearing corporation transfer at the top of the chain.\footnote{343}

UTP fits comfortably within the clearing corporation transfer paradigm. Indeed, the sharpest vision of seniority for clearing corporation participant-transferees appears from recognizing such treatment as a discrete example—a subset—of the more general principle of UTP. Although current law generally rejects bona fide purchaser treatment for transferees of interests in fungible bulks through intermediaries; transfers through clearing corporations are exceptional because they essentially occur only at the \textit{top tier}.\footnote{344} It follows that the result for clearing corporation transferees under current law would not be changed by UTP. UTP would, however, confer seniority on transferees on the books of any intermediary over claimants on the downstream chain from that transferee, are indirectly enhanced because they essentially occur only at the \textit{top tier}.

UTP would complement negotiability as embodied in Article 8 by providing a priority scheme, other than first-in-time, as among market participants that do not achieve bona fide purchaser status.

\footnote{343 Such downstream claimants benefit directly or indirectly from the shelter principle. See U.C.C. § 8-301(1); pre-1978 § 8-301(1); supra note 88. Moreover, clearing corporation participants would be unlikely to undertake warranty and contractual obligations to customers in the absence of assurance that they have received good title to securities involved. See infra Part V(B) (discussing warranty obligations of securities intermediaries).

344 Assuming a clearing corporation is at the top tier, the same result would be obtained under UTP whether or not bona fide purchaser status were conferred on clearing corporation book-entry transferees. However, securities transferred pursuant to 1978 and pre-1978 § 8-320 can be controlled by a clearing corporation through a custodian bank or another clearing corporation and, consequently, are not necessarily at the highest tier. U.C.C. § 8-320(1)(a); pre-1978 § 8-320(1)(a). This approach can be rationalized on the basis of the inherent safety perceived to be associated with clearing corporation control generally. See supra note 342. The wisdom of bona fide purchaser status for clearing corporation participant transferees has been questioned, apparently on the basis that clearing corporations are conceptually the same as other financial intermediaries. Arostein, Haydock & Scott, supra note 5, at 909-10 & n.99. But the vision of a clearing corporation at the top tier effectively neutralizes this criticism. Bona fide purchaser status for a transferee under U.C.C. § 8-313(1)(c) (customer name securities) and § 8-313(d)(1) (specifically identified certificated securities) also conforms to this vision. See U.C.C § 8-313(1)(c), (d)(1); pre-1978 § 8-312(1)(b)-(c). Because such a transferee’s intermediary (though it is not a clearing corporation) is in possession of a specific certificated security, that intermediary is at the top of the chain and there can be no upper-tier claimants. To the extent that the doctrine of constructive possession applies, however, the analogy admittedly is weakened. See supra note 221. Bona fide purchaser treatment for transferees of specifically identified securities also has been criticized on the basis that risks are greater when securities are controlled by “ordinary” intermediaries than by clearing corporations. Arostein, Haydock & Scott, supra, at 916. But that treatment can be rationalized by recognizing that such identifications are unusual and normally occur only in the process of making a physical delivery to a customer. See Appendix II, infra note 8.}
And it would provide a clearer doctrinal rationale for Article 8's treatment of bona fide purchaser status in cases that do not conform to the physical delivery paradigm.


An “entrusting of possession of goods to a merchant who deals in goods of that kind” empowers the merchant “to transfer all rights of the entrustor to a buyer in [the] ordinary course of business.”\(^{345}\) As between the entrustor and certain buyers, this rule recognizes that the loss should fall on the entrustor. The same can be said of the subordination of trust beneficiary claims to the rights of good faith purchasers of trust property from trustees.\(^{346}\) UTP embraces a similar result. By allowing I-1, its securities intermediary, to control its securities, a lower-tier claimant such as C-1 has put the securities “in play.” UTP would subordinate the lower-tier claim to those of subsequent upper-tier transferees like I-2 and L.\(^{347}\)

Although UTP is faithful to the principle of the entrustment paradigm, it varies from it in certain matters of detail.\(^{348}\) There are other U.C.C. analogues to UTP that subordinate or cut off the rights of those who put property in the control of others,\(^{349}\) although these analogues also differ from each other in detail and context. UTP is somewhere near the mainstream of a general principle that appears in

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\(^{346}\) See supra note 258 and accompanying text.

\(^{347}\) C-1, by not taking possession of A Co. and B Co. securities or causing them to be transferred to C-1 through an intermediary other than I-1, has put I-1 in a position to confer bona fide purchaser status on J-2 and L. UTP would provide seniority to J-2 and L without their need to incur (and pass on to J-1) the costs of becoming bona fide purchasers.

\(^{348}\) The differences flow from differences in context rather than principle. For example, the entrustment rule favors a relatively narrow class of beneficiaries — “buyers in ordinary course of business.” See supra note 345. UTP would provide seniority for any upper-tier transferee, including a secured party who could not qualify as a “buyer in ordinary course of business.” U.C.C. § 1-201(9). In effect, UTP would conclusively presume that transfers between and among securities intermediaries and investors are ordinary course transactions.

\(^{349}\) For example, one with property rights in goods that predate the bailment of the goods and the issuance of a negotiable document of title generally will retain senior rights in the goods even if the document subsequently is duly negotiated. U.C.C. §§ 7-302(1), 7-503(1). But, when the earlier claimant to property rights has itself put the goods in the stream of commerce, its rights will be cut off by a subsequent claimant to whom the document is duly negotiated. U.C.C. § 7-503(1). The interest of a consignor of goods delivered to another person for sale also may be subordinated to claims of creditors of the person in possession of the goods unless the consignor complies with certain public notice requirements. U.C.C. § 2-326.
various contexts under current law—one who puts property in a stream of commerce may be exposed to having its rights cut off or subordinated by certain classes of later-in-time competing claimants.\footnote{As to upper-tier claimants that are \textit{earlier}-in-time, the subordination of lower-tier claimants, resulting from denial of bona fide purchaser status under current law, is consistent with the \textit{nemo datus} principle. See supra note 88. It also conforms to certain provisions of the U.C.C. and other law that may apply when a buyer leaves a seller in possession. For example, the better (but not uniform) view is that a buyer will not be entitled to "buyer in ordinary course of business" status unless it obtains possessory rights in goods (which normally means that delivery must have occurred). See Frisch, Buyer Status Under the U.C.C.: A Suggested Temporal Definition, 72 Iowa L. Rev. 531, 556-67 (1987). But see Tanbro Fabrics Corp. v. Deering Milliken, Inc., 39 N.Y.2d 632, 350 N.E.2d 590, 385 N.Y.S.2d 260 (1976) (buyer in ordinary course of business can take free of security interest under § 9-307(1) even though seller's secured party is in possession of goods). The retention of possession by a seller also might constitute a fraudulent conveyance. See, e.g., Moorey, supra note 124, at 726-29 and authorities cited therein.}

c. \textit{Money and Bank Accounts}

The treatment of money and bank accounts also lends support to a new model not based on a property law construct.\footnote{Tracing principles are applied, however, as among and between certain claimants to funds commingled in the same bank account. For critiques of these principles, see generally Oesterle, \textit{Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity} and in U.C.C. § 9-306, 68 Cornell L. Rev. 172 (1983); Rogers, Negotiability, supra note 15.} Money consists largely of unsecured claims against banks—deposits.\footnote{Tracing the evolution of money and payment mechanisms from the exchange of tangible currency (including privately issued negotiable instruments) to the exchange of unsecured claims against banks (deposits) is beyond the scope of this article. See generally W. Carlin, \textit{The Evolution Of Modern Money} (1901 & photo reprint 1967); J. Hurst, \textit{A Legal History Of Money In The United States}, 1774-1970 (1973); J. Galbraith, \textit{Money, Whence It Came, Where It Went} (1975); J. Melitz, \textit{Primitive And Modern Money} (1974). Yet even a superficial consideration of the role of banks as intermediaries in the payment system may provide some insights for the securities world.} The inadequacy of physical deliveries of currency as a means of payment in a commercial society is obvious. It is hard to imagine a legal regime that routinely would resolve the rights of bank depositors among themselves and others by tracing property interests in currency in order to determine who ultimately "owned" the currency.\footnote{A bank deposit normally creates a debtor-creditor relationship between the bank and the depositor (customer). See 5A Michie On Banks And Banking 1 (1983 Replacement); 9 C.J.S. Banks and Banking § 267(c), at 546 (1938 & Supp. 1950). The new U.C.C. Article 4A—Funds Transfers provides a striking example of the extent to which claims against banks typically constitute money: A payment to a payee is completed when the payee's bank becomes obligated to the payee. U.C.C. § 4A-104(1) & comment 1 (1989). Article 4A also recognizes the overarching significance of the selection of a particular intermediary bank by the sender of a payment order. U.C.C. § 4A-402(3) (1989) (sender who specifies routing through a particular intermediary bears risks of that intermediary's insolvency or legal inability to complete payment order).} The sys-
tern for transfer and pledge of interests in fungible bulks of securities has come to resemble the system of bank deposits in that these transfers and pledges typically take place through book entries on the books of intermediaries. Yet the legal regime continues to treat property interests in fungible bulks of securities more like property interests in currency than accounts with intermediaries.

The effects of intermediary insolvencies on securities customers and securities market operations are similar in several respects to the effects of bank insolvencies on depositors' claims and funds transfer systems. Small customer claims, like small depositor claims, are protected by a form of "insurance." If there are insufficient securities to satisfy customer claims, most customers will share pro rata, as is the case for uninsured depositors in a bank insolvency who are treated as general creditors. In many (but not all) cases claims of customers of a securities intermediary will be junior to claimants that are transferees on an upper tier, and, in any event, tracing of property interests in securities is often impracticable. If a bank or a securities firm fails, depositors and customers alike may well be losers.

Certainly there are important functional and legal differences between bank deposits and securities claimed through intermediaries. But consider that securities generally were not treated as negotiable instruments until this century. And only in last few decades have securities market practices and transaction volume demonstrated that physical deliveries and the routine establishment of issuer-beneficial owner relationships are not feasible. Because the functional similarities of bank-depositor and securities intermediary-customer rela-

354 Deposit accounts up to $100,000 are insured by the FDIC. 12 U.S.C. § 1817(i), 1821(a) (1989); 12 C.F.R. § 330.2, 330.10 (1990). See supra notes 8, 171 (SIPC protection for customers of registered broker-dealers).

355 See generally supra Part III. To the extent that SIPC satisfies customer claims it is subrogated to those claims and, accordingly, shares pro rata with other customer claims not so satisfied. See SIPC, § 9(a), 15 U.S.C. § 78lll(9)(a).

356 12 U.S.C. § 194 (1983); see Macey & Garrett, supra note 297, at 217; Note, supra note 297, at 617. Customer claims in respect of customer property, however, are senior to general creditor claims under SIPA and Subchapter III. See supra notes 173-78 and accompanying text.

357 See generally supra Part IV.

358 Because all dollars are inherently fungible, depositors' claims against banks are different from claims to specific types of securities controlled by securities intermediaries. Indeed, money is the medium through which all claims ultimately can be satisfied. Moreover, banks create money; bank deposits are not "backed up" by equal value in currency or other reserves of money-like quality. See, e.g., M. Stigum, The Money Market 13-15 (rev. ed. 1983). To use Article 8 terminology, banks are analogous to "issuers" of deposit obligations. Securities, however, are not supposed to be "created" by securities intermediaries.

359 See generally Gilmore, supra note 332, at 1072-76.

360 See generally supra notes 23-51, 125 and accompanying text.
tionships are of such recent origin, it is not surprising that the property construct persists so strongly in the legal regime for transfers of securities. In this sense, a new model such as UTP can be viewed as an appropriate adjustment of the legal regime to the realities of market expectations and behavior.

d. Observations

Where UTP would override the first-in-time principle it finds support in analogous exceptions elsewhere in the U.C.C. Although the general conformity with analogous doctrine does not, alone, demonstrate the wisdom of UTP, this consistency in result does provide support for UTP when considered together with economic analysis grounded on reasonable assumptions and the fact that the details of good faith purchaser treatment are something on which reasonable people can disagree. The harmony also indicates that UTP is viable on practical as well as conceptual grounds\textsuperscript{361} and is not likely to conflict with widely held normative views.\textsuperscript{362}

B. The Corollary: Broad Intermediary Warranties

UTP contemplates that the transferee of an interest in a fungible bulk of securities on the books of an intermediary may look only to that intermediary for satisfaction. As a general proposition, one would expect the intermediary to be legally obligated to make available to the transferee the benefits of ownership, free of adverse claims, of the securities transferred—in effect, a warranty of good title.\textsuperscript{363} In

\textsuperscript{361} Because UTP contemplates a change in law, it cannot claim complete support from the existing legal regime. But it can be characterized as an evolutionary step that would conform the law to existing practices and expectations. See Clark, Abstract Rights Versus Paper Rights Under Article 9 of the Uniform Commercial Code, 84 Yale L. J. 445 (1975). Clark analyzes the "paperizing" of abstract rights into a single piece of paper (such as a negotiable promissory note or a certificated security) and the more "advanced" "recording principle" whereby priorities are determined by a system of public notice. Id. at 478-79. Clark concludes that no particular principle for ordering priorities is necessarily superior in all contexts. Id. at 479 ("One must look instead for the priority rule which, within a mixed system and in particular context of commercial practices and expectations, will most efficiently reduce . . . costs.").

\textsuperscript{362} See Phillips, Culpability, supra note 205, at 290 ("[T]he commercial culpability scale [a normative pattern in the U.C.C.] can be a powerful tool both to understand current commercial law and to identify areas for legislative reform.").

\textsuperscript{363} For simplicity of exposition this discussion addresses "warranty of title" obligations of intermediaries as a corollary of UTP, although a different means of expressing the intermediary's obligations could be employed were UTP and its corollary codified. In general terms, the warranty should be such that, if honored, the transferee would receive all of the benefits of the interest to be transferred. The warranty should not extend to defects or defaults where the issuer is at fault, since the qualities of the issuer and the issuer's behavior comprise risks properly assumed and borne by the transferee. It would seem to follow that when securities that are invalidly issued by the issuer are included in a fungible bulk—arising from an overissue, for
the absence of such a broad obligation, the existence of a senior upper-tier adverse claim could leave the transferee with no remedy at all, even though its intermediary remained solvent and viable. The rationale for allocation of loss to lower tier claimants rather than upper tier claimants requires, as a baseline rule, the ultimate allocation of loss to the intermediaries of such lower-tier claimants.

A broad warranty of good title would recognize that an intermediary, rather than its transferee-customer, could reduce or avoid losses arising from adverse claims for a lower cost. It would encourage an intermediary to control securities in a manner that reduces the risks and costs of adverse claims. And the warranty received by an intermediary from its own upstream intermediaries would enhance the ability of the intermediary to give and honor its own warranty to its transferee-customer. That is, subordination of lower tier claims would make warranties by intermediaries less risky.

Article 8 now imposes certain warranties on transferors of securities—an intermediary should not bear the loss. See U.C.C. § 8-104 (effect of overissue). How the various claimants to a fungible bulk through intermediaries would share in such losses must be addressed, but that matter is not developed here.

Another form of risk posed by intermediary control of securities also warrants attention. Assume that a securities issuer pays dividends, principal or interest to security holders of record and thereby is discharged of its obligation. Assume further that a disruption in the payments system (perhaps caused by a bank failure) prevents a lower tier claimant's intermediary from receiving that payment for redistribution to its customers. It is not clear who would bear the loss under current law.

The obligations of the intermediary also could be made the subject of a contract with its customer. In many situations an intermediary will be required by applicable law and regulations outside of the U.C.C. to maintain control of customer securities free of adverse claims. See supra notes 61-62 and accompanying text.

By taking possession and examining the securities to ensure that a good delivery has been made, or by receiving a transfer to the account of the intermediary with a clearing corporation, the intermediary could ensure that it achieved bona fide purchaser status. Or, the intermediary (such as I-1) could choose to receive a transfer of the securities in its account with another intermediary (such as I-2) that is not a clearing corporation. In the latter case, the intermediary could protect itself (and the transferee) by choosing its upstream intermediary with care. A transferee such as C-1, however, would have little or no control (except by contract with the intermediary) over the means of protecting against adverse claims.

The absence of such warranty obligations could present a moral hazard problem. The intermediary could choose to control its transferees' securities in the least costly manner, even if it were risky, in order to reduce its own costs. The existence of adverse claims would be riskless to the intermediary. In addition to inducing care on the part of intermediaries, a broad statutory warranty also might encourage innovation in the marketplace that would further reduce the incidence of adverse claims.

UTP would award seniority to I-2 and to L (as I-2's transferee) as against lower tier claimants by customers of I-1. I-2, then, would incur less risk in making a broad warranty in favor of L because I-2 could ignore the prospect of lower tier adverse claimants, such as C-1, who are claiming through I-1.
ties, but in at least three respects Article 8 may fail to conform with the broad warranty necessary for a UTP regime. First, Article 8 does not provide expressly that a transferor of a security gives a warranty of good title. Rather, a transferor of a security warrants to a purchaser for value that the "transfer is effective and rightful." Properly construed, however, "rightful" should encompass a warranty of good title and freedom from adverse claims.

Second, and more troublesome, it is not clear that an intermediary effecting a transfer on its books is, itself, necessarily a transferor. Consider the transfer of a security interest to L in Example 1. The underlying secured loan was between I-1 and L, although the transfer occurred on the books of I-2 (who was not a party to the underlying transaction). But all aspects of effecting the transfer to L were within the sole control of I-2. L knew only that it received a confirmation from I-2 and that, under its agreement with I-2, I-2 was...

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368 See U.C.C. § 8-306 & pre-1978 § 8-306. See generally Guttman, supra note 4, at 6-5 to 6-9, 6-21 to 6-25.

369 U.C.C. § 8-306(2)(a) (transferor of certificated security); U.C.C. § 8-306(9) (transferor of an uncertificated security, who does not "originate an instruction"). The transferor of an uncertificated security who "originate an instruction," however, warrants to a purchaser for value that "the transfer ... will be registered by the issuer free from all liens, security interests, restrictions, and claims other than those specified in the instruction," and, in addition, that "the requested transfer ... will be rightful." U.C.C. § 8-306(7)(c)(ii)-(iii). Does this imply that "rightful" is a wholly separate concept that does not encompass good title and freedom from adverse claims? (The concept of "good title" is not mentioned in § 8-306.) The Official Comment indicates that no such implication should be drawn. See U.C.C. § 8-306 comment 7 (The "warranties [under § 8-306(7)] are similar to those made by one transferring a certificated security, subsection (2), the principal difference being the absolute warranty of validity"); see also Reporter's Comment, supra note 5, § 8-306, at 568 ("Subsection (7) ... is essentially identical to the warranty of the transferor of a certificated security under subsection (2).")

370 See Morgan Guar. Trust Co. v. New England Merchants Nat'l Bank, 438 F. Supp. 97, 101-02 (D. Mass. 1977) (when bona fide purchaser of security retransferred to second transferee, second transferee took free of adverse claims and, therefore, § 8-306(2) warranty of "rightful" transfer to second transferee was not breached). Other provisions in Article 8 support this conclusion. See U.C.C. §§ 8-302(2) (defining "adverse claim" to include "a claim that the transfer was or would be wrongful"); 8-304(3) (purchaser's notice that security held for third person or registered to or indorsed by fiduciary "does not create a duty of inquiry into the rightfulness of the transfer or constitute constructive notice of adverse claims"); 8-315(1) (remedies of a person "against whom the transfer of a security is wrongful") & 8-315(2) (remedies of owner of security when "transfer is wrongful because of an unauthorized indorsement"); see also U.C.C. § 8-306 comment 7 (quoted supra note 369). Provisions elsewhere in the U.C.C. also are supportive. See U.C.C. §§ 2-312(1)(a) (warranty by seller of goods that "title conveyed shall be good, and its transfer rightful"); 3-417(2)(a) (transferor of instrument warrants that "he has a good title to the instrument ... and the transfer is otherwise rightful"). Guttman agrees with the conclusion stated in the text, but he extracts a warranty of freedom from adverse claims from the word "effective." See Guttman, supra note 4, at 6-7.

371 The warranties to such a transferee are made by the person who transfers the securities. U.C.C. § 8-306(2), (9).

required to reflect the transfer on its books. Was I-2 the transferor to L? Was I-1 the transferor to L? Were they both transferors to L? Was I-1 the transferor to I-2 and was I-2, in turn, the transferor to L? Article 8 provides no clear answers to these questions. As in the underlying priority contest, the transferor-transferee property law construct of Article 8 fits poorly with transactions in fungible bulks of securities controlled by intermediaries.

Even if I-2 was not a transferor, I-2 probably would make the warranties made by a transferor because I-2 appears to have been a broker, acting for L, in this transaction. But if an intermediary effecting a transfer on its books were not a transferor, it would not make any warranties if it were not acting as a broker. The definition of "financial intermediary" contemplates that some financial intermediaries will not be "brokers." Thus, it is possible that a financial intermediary effecting a transfer on its books may be neither a transferor nor a broker.

373 Although Article 8 expressly provides for transfer of interests in fungible bulks of securities by intermediary book entries, it fails to specify who is the transferor for purposes of transferor warranties.

374 U.C.C. § 8-306(10) provides:

A broker gives to his customer and to the issuer and a purchaser the applicable warranties provided in this section and has the rights and privileges of a purchaser under this section. The warranties of and in favor of the broker, acting as an agent are in addition to applicable warranties given by and in favor of his customer.

"Broker" is defined as "a person engaged for all or part of his time in the business of buying and selling securities, who in the transaction concerned acts for, buys a security from, or sells a security to, a customer." U.C.C. § 8-303.

375 U.C.C. § 8-306(10) implies that an intermediary effecting a transfer on its books is not necessarily a transferor; otherwise, imposing transferor warranties on a broker, as such, would not be necessary. I-2 would be acting merely as an agent of L, a disclosed principal, and also as an agent for I-1, another disclosed principal. But it is also plausible that I-2 would be treated as a transferor. Imposing warranty liability on intermediaries acting as brokers may be merely a means of overriding any arguments based on agency that an intermediary should be relieved of otherwise applicable warranties.

376 U.C.C. § 8-313(4). Although it would seem that a financial intermediary effecting a transfer on its books would normally be "acting for . . . a customer," some financial intermediaries, such as certain custodian banks and clearing corporations, may not be "in the business of buying and selling securities." See U.C.C. § 8-303 (defining "broker") (quoted supra note 374). Yet it would be anomalous if such an intermediary, normally viewed as the safest type of intermediary, would not be held to any warranty liability. Certain intermediaries are relieved of transferor warranty liability pursuant to U.C.C. § 8-306(3) when "a certificate of security is delivered by an intermediary known to be entrusted with delivery of the security on behalf of another . . . ." Such intermediaries warrant only their "own good faith and authority," U.C.C. § 8-306(3). See generally Guttman, supra note 4, at 67-72. But U.C.C. § 8-306(3) would not apply in the normal book-entry transfer that involves no "delivery." Considering that even these intermediaries make some warranties, it seems unlikely that Article 8 would entirely absolve non-broker intermediaries effecting transfers on their books from warranty liability. Thus, the better interpretation is that such intermediaries are transferors when they effect transfers by book entry.
Third, transferor warranties extend only to "purchasers for value." UTP is grounded on the notion that a claimant can best protect itself by careful selection of its intermediary. Consider, then, the claimant who becomes concerned about, or otherwise dissatisfied with, its intermediary, and instructs its intermediary to transfer securities credited to its account to a different intermediary. Surely it is just as crucial to the claimant that it receive warranties of good title from the new intermediary, even though the claimant has not given value (other than a transfer fee, perhaps) in connection with the "free" transfer. The new intermediary is (as was the old) in exclusive control of the means of effecting a transfer and controlling the securities.

Warranties imposed by the Proposed TRADES Regulations for Treasury securities also are problematic. Those proposed regulations contain an unusual prohibition on disclaimers and limitations of warranties. Warranties under Article 8, on the other hand, generally may be varied by agreement. Broad warranties provide fallback rules that, when modified, force affirmative disclosure and explication of deviations from the standard, but they need not be inflexible. Some risks might more properly be attributed to the inherent characteristics of the securities themselves rather than to matters that

377 U.C.C. § 8-306; see U.C.C. § 1-201(44) (defining "value").
378 For an extreme example, suppose that the new intermediary chose to allow the old intermediary to continue to control the securities as part of a fungible bulk by merely crediting the new intermediary's account with the old intermediary. If the securities were already subject to an adverse claim, the claimant could be disadvantaged because the new intermediary chose not to receive securities in a manner that would afford bona fide purchaser status to the new intermediary.
379 Unless the book-entry custodian is itself a "transferor," the warranty made by a book-entry custodian "[i]n connection with any transfer of a security" covers freedom from adverse claims granted by the custodian (unless disclosed) and those of which the custodian has knowledge—but it falls short of a complete warranty of good title and freedom from adverse claims. Proposed TRADES Regulations, supra note 7, § 357.17(a). If the book-entry custodian is the transferor, however, it additionally "warrants to the transferee that the transfer is rightful and effective" (i.e., a warranty of good title and freedom from adverse claims). Id. § 357.17(b); see supra note 366. A transferor who is not a book-entry custodian also makes the "rightful and effective" warranty. Proposed TRADES Regulations, supra note 7, § 357.17(c). Presumably, when two parties to a trade are known to each other the transferring party will be a (non-book-entry custodian) transferor for purposes of that warranty. But the TRADES framework fails to illuminate the circumstances that will cause a book-entry custodian to be a transferor to its customer. Presumably, if the book-entry custodian is a dealer, or, perhaps acting as a broker for its customer, it will be a transferor, but there is no analogue to U.C.C. § 8-306(10). See supra note 374. The TRADES approach strongly suggests, however, that a clearing bank or custodian that acts only to receive transfers of securities for its customer will not be a transferor and, consequently, will not make a warranty of good title and freedom from adverse claims.
380 Proposed TRADES Regulations, supra note 7, § 357.17(f).
381 U.C.C. § 1-102(3).
an intermediary could be expected to control. For example, some securities issued by foreign issuers must remain under the control of a foreign depository or custodian, notwithstanding trading activity in the United States markets. When proper disclosure is made, risks associated with the foreign depository or custodian might better be allocated to United States investors instead of to their intermediaries. At least as among professional market participants, the matter of warranties should be left to variation by explicit agreement of the parties.

The scope of transferor warranties does not appear to have given rise to many problems or disputes. The warranty provisions under Article 8 have figured in few reported decisions relating to freedom from adverse claims. Perhaps market practices and mores dictate that solvent and honest intermediaries do not seek to pass on risks of adverse claims to their transferees and customers. And when an intermediary becomes insolvent a warranty claim would be only an unsecured claim in any event. But the paucity of litigation does not undermine the importance of the corollary. The rationale for allocation of loss to lower-tier rather than upper-tier claimants requires, as a baseline rule, the ultimate allocation of loss to the intermediaries of such lower tier claimants.

C. Treatment of Non-Innocent Upper-Tier Transferees

So far the examination of UTP has left open the treatment of non-innocent upper-tier claimants. Based on moral grounds, a non-innocent transferee ought not to be awarded with a senior claim and also be left unsanctioned. It is wrong to knowingly divest a person

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382 Transferor warranties, per se, are only part of the picture. In organized markets a form of broad warranty generally prevails among market participants. When a market participant transferor fails to conform to standards of “good delivery” the transferee is granted a right of “reclamation.” See generally Guttman, supra note 4, at 8-31 to -37. And following a transfer that complies with all applicable warranties and delivery standards, customer protection rules dealing with segregation and control of securities by intermediaries afford additional protections. See supra notes 61-62 and accompanying text.

383 James J. White has suggested to me that because one goal of UTP is a clear and certain rule, sanctions against a noninnocent upper tier transferee might be the “exception that swallows the rule.” The response must be that in some cases certainty and efficiency should give way to other values. Moreover, UTP is justified to some extent by the assumption that it is difficult or impossible for upper-tier claimants to discover adverse claims. Sanctions against a noninnocent claimant would assume that the claimant already has knowledge of a lower tier claim. Some might not agree that sanctions against noninnocent transferees always would be proper. For example, priorities as among secured creditors claiming personal property collateral are generally believed to turn on the time of filing or perfection irrespective of knowledge by a secured party of an unperfected security interest that is prior in time. See U.C.C. § 9-312(5)(a); compare Carlson, Rationality, supra note 142, passim (arguing that knowledge standard should be applied on normative grounds and that the U.C.C. can be construed to embrace a knowledge standard notwithstanding common assertions to the contrary) with Baird & Jack-
(the lower tier claimant) of its property rights, especially when acting in complicity with a party (such as the lower-tier claimant’s intermediary) that is violating its obligations to that person. Beyond this general notion, however, adopting a UTP scheme could suggest some alternatives to current law for treatment of non-innocent upper-tier claimants.

What should be the standard for non-innocence? One obvious alternative is the current standard for determining whether a purchaser has notice of an adverse claim for purposes of bona fide purchaser status. Arguably, the standard should be actual knowledge of wrongfulness where fungible bulks are concerned.

What sanctions should apply to non-innocent claimants and in whose favor should the sanctions be applied? The usual property law construct embodied in priority rules would allow a lower-tier claimant, such as C-1, to recover the securities, or the value of the securities, from a non-innocent upper-tier claimant, such as I-2 or L. In the context of fungible bulks of securities, however, a lower-tier claimant, such as C-1, may not be the appropriate party to recover the securities or damages. Because the priority contests arise by virtue of I-1’s insolvency, if the A Co. and B. Co. securities had not been transferred wrongfully by I-1 to I-2 and L, those securities would have been subject to the SIPA/Subchapter III risk sharing distributional rule. It would seem to follow that I-1’s trustee in the insolvency proceedings should succeed to the claim against a non-innocent claimant, supra note 142, at 314-18 (arguing that knowledge standard should not be applied based on excessive costs and nonequivalence of knowledge and bad faith).

384 See U.C.C. §§ 1-201(25) (“A person has notice of a fact when . . . from all the facts and circumstances known to him at the time in question he has reason to know that it exists.”), 3-304(3) (modifying notice definition of U.C.C. § 1-201(25) for purposes of notice of adverse claims under Article 8, to the effect that notice that security is held for or registered to third person does not create duty of inquiry and knowledge that transaction is in breach of duty does constitute notice of adverse claims).

385 In Example 1, I-2 may be in possession of much information concerning I-1 and its customers as a result of trade tickets, subaccounts, and the like. Charging I-2 with knowledge of that information would miss the point that I-2 normally would not be equipped to pay attention to such information, even if it could be extracted and computed from its records. The problem is greatest when an upper-tier intermediary serves a clearing or carrying function for a downstream intermediary. Where immediate andmediate innocent transferees from the non-innocent claimant are concerned, however, the principle of UTP would give seniority to all innocent upper-tier claimants, even those who derive their interests from a non-innocent person.

387 If a lower-tier claimant’s intermediary were not insolvent, that claimant probably would be satisfied by its intermediary, either on a warranty theory or based on the intermediary’s obligation to control securities free of adverse claims on behalf of the lower-tier claimant. Thus, were the intermediary not insolvent, it is likely that the lower-tier claimant would never discover a wrongful upper-tier transfer.

388 See generally supra Part III.
That result would be a fundamental departure from current bankruptcy law that permits a trustee to succeed only to the avoidance powers of actual unsecured creditors. But it is fully consistent with the risk sharing distributional rules in securities firm insolvencies. It is anomalous that current law does not permit the insolvent intermediary’s representative to recover such damage claims.

CONCLUSION

The pervasive phenomenon of intermediary control of securities in fungible bulk in the securities markets meshes poorly with traditional property law doctrine. Much of this article is devoted to an analysis of transfer, pledge, and priority under Article 8. The enormous uncertainty, complexity, and difficulty of interpretation and application must be seen, in tedious detail, to be appreciated. Disagreements and misunderstandings are not surprising. The evidence is convincing that the results and implications of current property law as applied to securities controlled by intermediaries in fungible bulk have not been thought through. These considerations

389 Allowing I-1’s trustee, rather than C-1, to recover from the non-innocent I-2 and L would not violate C-1’s property rights because including the recovery as a part of customer property would allow C-1 to recover no less than it would have recovered if the wrongful transfers had not occurred. The trustee also might be more favorably situated to pursue such claims because of better information and economies of scale. Moreover, the trustee would not necessarily be required to prove that the upper-tier transferee’s conduct was wrongful as to any particular customer’s securities. A lower-tier customer, however, would be forced to demonstrate, such as through tracing, that its property was wrongfully transferred to the upper-tier transferee.

390 See 11 U.S.C. § 544(b) (1988) (trustee in bankruptcy can avoid transfer of property or obligation incurred by debtor that can be avoided by an actual unsecured creditor under applicable law). This avoidance power extends to the entire interest in property transferred and is not limited by the extent to which an actual unsecured creditor could so avoid a transfer. Moore v. Bay, 284 U.S. 4 (1931). Although a trustee in a Subchapter III proceeding can exercise avoidance powers with respect to prepetition transfers of property that would have been customer property, the claims of lower-tier claimants to securities in the hands of upper-tier claimants would not be unsecured claims, and damage claims would not be avoidance powers. Therefore, recovery under 11 U.S.C. §§ 544(b) would not be allowed. 11 U.S.C. §§ 544(b), 749(a). The results under SIPA would be the same. See SIPA, §§ 6(b), 7(a), 8(c)(3), 15 U.S.C. §§ 78ff-1(b), 78ff-1(a), 78ff-2(c)(3) (1988). But if the transfers were made with actual fraudulent intent, or if the transfers were not made for value and the transferees were not in good faith, then a trustee could recover the securities or their value from the transferees under current law. See 11 U.S.C. §§ 548(a)(1), (c), 550(a)(1).

391 Similar anomalies exist with respect to preferences under SIPA and Subchapter III. See supra note 196. Note that in some cases it will be SIPC that can assert a claim against an upper-tier claimant because, under current law, SIPC is subrogated to customer claims to the extent it has advanced funds to satisfy such claims. SIPA, § 9(a), 15 U.S.C. § 78ff-3(a) (1988).
alone are reason enough to commend thoughtful contemplation of a simpler and more rational legal regime.

The solvency and integrity of an intermediary is the touchstone that largely determines how the interest of a claimant to securities through that intermediary will fare under current law (and any other system that I can think of). For this reason, intermediary solvency and integrity should lie at the core of the treatment of fungible bulk transfer, pledge, and priority. Recognition of this touchstone also has a powerful explanatory effect. Its acceptance and recognition as reality in the market no doubt account for why securities market settlements systems function as well as they do, notwithstanding confusion and disagreement concerning application of current law.

The distributional rules for customers under SIPA and Subchapter III provide a model for same-tier claimants grounded on equality of treatment rather than a property construct. Where those regimes do not apply, as in bank insolvencies, a conforming sharing principle should be imposed by a change in applicable state law. But even under SIPA and Subchapter III, current law relating to preferences and avoidance powers can yield anomalous results.

Where different-tier claims are involved, current law is unprincipled and arbitrary. The UTP (upper-tier priority) principle advocated here is a proposal for a non-property law construct rule to resolve different tier priority contests. But its details are less important than moving the legal regime toward a more precise vision of the sui generis characteristics of the (not-quite-property, not-quite-unsecured claim) relationship that results when interests in fungible bulks of securities are transferred on the books of intermediaries. The need for a new model concerns not only the substance of codified rules, but also recognition of intermediary risk as a central determinant of appropriate doctrine. The proposal for UTP, properly grasped, is a step toward the development of a theoretical and normative basis for transfer and pledge by intermediary book-entry. A new model, divorced from common law and U.C.C. property law constructs, also could form a more plausible base for unification of law on the international level. An approach not rooted in longstanding domestic doctrine might provide a more likely basis for harmonizing widely varying doctrine in other nations.

Thoughtful articulation of a better conceptualization also might ward off unsound proposals such as the last-in-time good faith transferor rule of the Proposed TRADES Regulations. Perhaps it also will encourage exploration of non-property oriented approaches in other
markets and other contexts where the baggage of a property law construct may not be appropriate.

Finally, there is another story, not fully told, that is implicit in this article. Legal rules for private property rights, such as Article 8, the Book-Entry Treasury Regulations, and the Proposed TRADES Regulations, are unlikely media for fully addressing concerns about the protection and safety of those who receive transfers and pledges of securities through intermediaries. Financial institutions that serve as securities intermediaries have special roles and characteristics. A prudent regulatory approach to inherent intermediary risk, coordinated with property law, may provide a more feasible route to enhanced safety. In addition, future innovations in technology and settlement systems might increase direct relationships between market participants and issuers and permit less reliance on intermediary control. But, to repeat, that is another story.
APPENDIX I

The following is a copy of Section 8-313 of the U.C.C. as it appears in the 1978 and current version of the official text. The text in brackets represents the deletions made from the pre-1978 version and the underlined text represents 1978 additions.

U.C.C. Section 8-313.


(1) [Delivery] Transfer of a security or a limited interest (including a security interest) therein to a purchaser occurs only [when]:

(a) at the time he or a person designated by him acquires possession of a certificated security; [or]

(b) at the time the transfer, pledge, or release of an uncertificated security is registered to him or a person designated by him;

(c) (b) at the time his [broker] financial intermediary acquires possession of a certificated security specially indorsed to or issued in the name of the purchaser; [or]

(d) (c) at the time [his broker] a financial intermediary, not a clearing corporation, sends him confirmation of the purchase and also by book entry or otherwise identifies [a specific security in the broker's possession] as belonging to the purchaser [: or]

(i) a specific certificated security in the financial intermediary's possession;

(ii) a quantity of securities that constitute or are part of a fungible bulk of certificated securities in the financial intermediary's possession or of uncertificated securities registered in the name of the financial intermediary; or

(iii) a quantity of securities that constitute or are part of a fungible bulk of securities shown on the account of the financial intermediary on the books of another financial intermediary;

(e) (d) with respect to an identified certificated security to be delivered while still in the possession of a third person, not a financial intermediary, [when] at the time that person acknowledges that he holds for the purchaser; [or]

(f) with respect to a specific uncertificated security the pledge or transfer of which has been registered to a third person, not a financial intermediary, at the time that person acknowledges that he holds for the purchaser;

(g) (e) at the time appropriate entries to the account of the purchaser or a person designated by him on the books of a clearing corporation are made under Section 8-320[.];

(h) with respect to the transfer of a security interest where the
debtor has signed a security agreement containing a description of the security, at the time a written notification, which, in the case of the creation of the security interest, is signed by the debtor (which may be a copy of the security agreement) or which, in the case of the release or assignment of the security interest created pursuant to this paragraph, is signed by the secured party, is received by

(i) a financial intermediary on whose books the interest of the transferor in the security appears;

(ii) a third person, not a financial intermediary, in possession of the security, if it is certificated;

(iii) a third person, not a financial intermediary, who is the registered owner of the security if it is uncertificated and not subject to a registered pledge; or

(iv) a third person, not a financial intermediary, who is the registered pledgee of the security, if it is uncertificated and subject to a registered pledge;

(i) with respect to the transfer of a security interest where the transferor has signed a security agreement containing a description of the security, at the time new value is given by the secured party; or

(j) with respect to the transfer of a security interest where the secured party is a financial intermediary and the security has already been transferred to the financial intermediary under paragraphs (a), (b), (c), (d), or (g), at the time the transferor has signed a security agreement containing a description of the security and value is given by the secured party.

(2) The purchaser is the owner of a security held for him by [his broker] a financial intermediary, but [is not the holder] cannot be a bona fide purchaser of a security so held except [as] in the circumstances specified in [subparagraphs] paragraphs [(b)] (c), (d)(i), and (e) (g) of subsection (1). [Where] If a security so held is part of a fungible bulk, as in the circumstances specified in paragraphs (d)(ii) and (d)(iii) of subsection (1), the purchaser is the owner of a proportionate property interest in the fungible bulk.

(3) Notice of an adverse claim received by the [broker] financial intermediary or by the purchaser after the [broker] financial intermediary takes delivery of a certificated security as a holder for value or after the transfer, pledge, or release of an uncertificated security has been registered free of the claim to a financial intermediary who has given value is not effective either as to the [broker] financial intermediary or as to the purchaser. However, as between the [broker] financial intermediary and the purchaser the purchaser may demand [delivery] transfer of an equivalent security as to which no notice of [an] adverse claim has been received.

(4) A “financial intermediary” is a bank, broker, clearing corporation
or other person (or the nominee of any of them) which in the ordinary course of its business maintains security accounts for its customers and is acting in the capacity. A financial intermediary may have a security interest in securities held in account for its customer.
1. First Draft

Section 13 of the first public draft of what was to become Article 8 (then called Article V) provided:

Section 13. When Delivery Effective To Complete Negotiation.

(1) Except as otherwise provided in this Section, delivery completing negotiation is received by a transferee when he or his agent acquires physical possession of an investment instrument, but a broker for the transferee is not his agent for this purpose unless the instrument is negotiated by special indorsement to the customer or by new issue in his name.

(2) Where a broker does not receive an instrument in the name of his customer or specially indorsed to him, delivery to the customer occurs when the broker sends confirmation of the purchase and also by book entry or otherwise identifies a specific instrument in his possession as belonging to the customer. In the absence of such identification the broker is the holder of the instrument despite confirmation of purchase or book entry or other indication that the instrument is part of a fungible bulk held for customers and despite the customer's acquisition of a proportionate property interest in such fungible bulk.

(3) When an identified instrument is in the hands of a third party the transferee receives delivery on attornment to him by the third party. ²

The Note to section 13 of the First Draft stated, in pertinent part:

This section deals with the kind of delivery which is necessary to effect a formal negotiation under Section 9. . . .

In this section the emphasis is put upon the receipt of physical possession of the instrument except in the case emphasized in subsections 2 and 3.

Subsection 2 conforms with the practice in brokerage houses.

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1 Although the following discussion dwells mainly on § 8-313 and its forebears, nothing in the drafting history of related sections, including §§ 8-301, -302, and -306, suggests conclusions different than those reached here.

so far as we have been able to determine what that practice is. We understand, however, that this particular practice applies in volume to only a very small percentage of the number of purchases made by a broker and that normally no such precise identification of an instrument takes place until such time as the customer demands delivery from the broker. Subsection 3 deals with the case where an identified instrument is in the hands of a third party.

It should be noted that so far as transfer of an instrument is concerned, notice of confirmation of a purchase should normally be sufficient to create ownership rights in the transferee even though the instrument itself may be merely in a fungible bulk safekeeping account or may in fact not be in the hands of the broker...

The First Draft incorporates four important and related principles that shed light on the meaning of both the pre-1978 and 1978 versions of section 8-313.

a. First Principle: A broker is not an agent for purposes of delivery except in the case of specially indorsed and customer name instruments.

Section 13(1) first states a general rule that delivery to a transferee occurs when “he or his agent acquires physical possession of an investment instrument,” thereby incorporating and acknowledging general principles of agency. That rule is followed by an exception—a broker is not the transferee’s agent except when the instrument involved is specially indorsed to the customer or issued in the customer’s name.

b. Second Principle: Only a “specific instrument” in a broker’s possession can be delivered to a broker’s customer by confirmation and identification.

Section 13(2) provides another exception whereby delivery to a customer can occur while a broker retains actual physical possession. The exception depends on the broker’s “confirmation of the

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3 First Draft, supra note 2, note to Section 13, reprinted in 3 Uniform Commercial Code Drafts, supra note 2, at 40 (emphasis added).
4 Id. supra note 2, § 13(1) (emphasis added). This clause is the forebear of both pre-1978 § 8-313(1)(a) and U.C.C. § 8-313(1)(a). Except for substituting the word “security” for the words “investment instrument” and the words “a person designated by him” for “his agent”, the first clause is essentially identical to the operative language of pre-1978 § 8-313(1)(a). Changes in style and terminology in the 1978 version were not intended to change the substance of paragraph (1)(a). See U.C.C. § 8-313(1)(a); U.C.C. § 8-313(1)(d)(i); U.C.C., app. 1, § 8-313, Reasons for 1977 Change, at 977 (“The rules of the present statute [pre-1978 § 8-313(1)] are preserved in subparagraphs (a), (c), (d)(i), (e) and (g) [of U.C.C. § 8-313(1)].”)

purchase” and identification of “a specific instrument in his possession as belonging to the customer.” The language “specific instrument” could hardly be more clear. In the absence of a good reason for a different interpretation, “specific instrument” could only be construed to mean a particular piece of paper that is somehow distinguished from every other piece of paper in the world. The second sentence of section 13(2) specifies that unless “such identification” is made, it is the broker, not the customer, that would be the “holder.” The second sentence clearly implies that an “indication that the instrument is part of a fungible bulk” is not an adequate identification so as to constitute a delivery under the first sentence.

The Note to section 13 further supports this construction of what constitutes a “specific security.” Such an identification was presumed by the drafters to occur only in “a very small percentage” of brokerage transactions and in the process of making an actual, physical delivery upon a customer’s demand.

c. Third Principle: An instrument can be delivered to a transferee through attornment by a third party (who is not the transferee’s broker) only if it is an “identified instrument.”

This principle, which springs from section 13(3) of the First Draft, addresses two separate issues. First, who can be a “third party”? In view of the references to a transferee’s and a customer’s broker in subsections (1) and (2), a “third party” could not include the transferee’s own broker. Presumably, however, the transferor’s broker could be the “third party.” Second, what is the meaning of “identified instrument”? The most plausible answer is that an “identified instrument” in subsection (3) has the same meaning as a “specific instrument” that has been “identified” under subsection (2).

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5 First Draft, supra note 2, § 13(2) (first sentence).
6 First Draft, supra note 2, § 13(2) (second sentence).
7 First Draft, supra note 2, § 13(1) (second sentence). Certainly a book entry specifying a customer’s interest in a specified quantity of a particular issue, of which an instrument is a part, would be inadequate to constitute such an identification of a “specific instrument.” When a fungible bulk is involved, presumably the quantity being transferred to a customer would always be indicated. And instruments comprising a bulk would not be fungible at all unless the instruments were of the same issue.
8 See First Draft, supra note 2, Note to Section 13, supra note 4.
9 First Draft, supra note 2, § 13(3). This subsection was the ancestor of what became pre-1978 § 8-313(1)(d) and U.C.C. § 3-313(1)(c).
10 It would be anomalous if a transfer by a broker to its customer could take two different forms—confirmation pursuant to section 13(2) and attornment pursuant to section 13(3).
11 The first sentence of subsection (2) refers to a broker that “identifies a specific instrument.” The second sentence then refers to “such identification.” Because these are the only
contrary rule that required a stringent test for identification of a "specific security" in the case of a broker's delivery to its customer, and a more relaxed standard for attornment by a "third party" to one not its customer, would make little sense.

d. Fourth Principle: Transfer to a broker's customer of a property interest in instruments controlled by the broker can occur without a delivery of the instrument.

The drafters contemplated that in the typical brokerage transaction, where no delivery by identification of a "specific instrument" occurs, a transfer of ownership rights to the broker's customer nevertheless would occur. 12 The second sentence of section 13(2) demonstrated the drafters' awareness of the distinction between transfer of a property interest and delivery of an instrument. As drafted, however, the provision did not provide expressly that such a transfer would occur. Instead, it merely contemplated that such a transfer would occur, presumably under common law outside of Article V. 13 In such non-delivery transfers, the broker would be the "holder" of the instrument even if the "instrument is part of a fungible bulk held for customers" and even if the customer acquires "a proportionate property interest in such fungible bulk." 14 Thus, if no specific instrument were identified, the customer would not receive an ownership interest in any particular instrument and the customer's interest would be only in the fungible bulk.

2. Second and Third Drafts

Section 30 of the second public draft was substantially un-

other references to the concept of identification, "identified instrument" in subsection (3) would appear to carry the same meaning.

12 First Draft, supra note 2, § 13(2) (second sentence).
13 See First Draft, supra note 2, Note to § 13(2) (quoted supra text at note 4) ("notice of confirmation of purchase should normally be sufficient to create ownership rights"). No other section of the First Draft contained any provision dealing with the method of non-delivery transfer of a property interest. See also State of New Jersey, Commission to Study and Report upon the Uniform Commercial Code for New Jersey, Second Report to the Governor, The Senate and The Assembly of the State of New Jersey 642, § 8-313 New Jersey Study Comments (1960), discussing pre-U.C.C. New Jersey common law:

It is clearly accepted that the moment a broker acquires securities for his customer, be it for a cash or similar consideration or on margin, the title to these securities vests in the customer, the broker retaining a right to be reimbursed for commission or balance of purchase price. . . . [T]he fact that title vests, must be considered subject to the broker's power to pledge fungible bulk. He need not deliver a specific security, but only a similar security, until the security becomes specified.

(citations omitted).
14 First Draft, supra note 2, § 13(2) (second sentence).
changed from section 13 of First Draft. The Second Draft did not disturb the four principles of First Draft. Moreover, the Second Draft clearly identified the purpose of delivery and holder status under the statutory scheme—eligibility for bona fide purchaser status so as to cut off competing claims. The third public draft contained no material changes.

3. Fourth and Fifth Drafts

Section 26 of the fourth public draft provided:

Section 26. When Delivery To The Purchaser Occurs; Purchaser’s Broker As Holder; “Attornment”.

(1) Delivery to a purchaser occurs when:

(a) he acquires possession of the security; or
(b) his broker acquires possession of a security specially indorsed to the purchaser or issued in his name; or
(c) his broker sends him confirmation of the purchase

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15 Uniform Commercial Code, Tentative First Draft No. 1—Article V (May 10, 1947) [hereinafter Second Draft], reprinted in 3 Uniform Commercial Code Drafts, supra note 2, at 286. The only material changes from section 13 of the First Draft were the deletion, in subsection (1), of the words “completing negotiation is received by a transferee” and the substitution of the words “to the purchaser occurs” therefor, and the deletion, throughout the section, of the terms “transferee” and “investment instrument” and the adoption of the substitute terms “purchaser” and “security,” respectively.

16 In particular, the note to section 30 of the Second Draft underscored the drafters’ perception that transactions involving identification of a “specific security” were not the norm: Generally under this section [30] the emphasis is placed upon actual receipt or physical possession of the security. Subsection (2) is designed to fit the practice in brokerage houses when an identified security is immediately set aside for the customer. This is far from the common practice, however, since normally no identification takes place until delivery is demanded by the customer. In such cases confirmation of the sale is sufficient to create ownership rights in the customer but he does not become a bona fide purchaser under Section 18 until specific identification of the security.

Second Draft, supra note 15, Note to Section 30, reprinted in 3 Uniform Commercial Code Drafts, supra note 2, at 313.

17 The Second Draft provided that a bona fide purchaser would acquire “a perfect title to the security.” Second Draft, supra note 15, § 18(2), reprinted in 3 Uniform Commercial Code Drafts, supra note 2, at 281. The definition of “bona fide purchaser” in the Second Draft was limited to purchasers that take delivery of a security. Id. § 18(1), reprinted in 3 Uniform Commercial Code Drafts at 280-81. A “holder,” similarly, was limited to one “in possession of a security.” Id. § 16(2), at 280. In view of this effect of delivery and holder status, the purpose of limiting delivery and denying holder status except in the case of actual physical delivery, specially indorsed and customer name securities, and securities that are specifically identified by a broker or attorning third party, under § 30 of the Second Draft, is made clear. The First Draft contemplated a similar operative rule that would be denominated “due negotiation.” See First Draft, supra note 2, §§ 10, 17.

and also by book entry or otherwise identifies a specific security in the broker’s possession as belonging to the purchaser; or

(d) attornment is made by a person other than the transferor with respect to an identified security.

(2) A broker not within paragraphs (b) or (c) of subsection (1) is the holder of the security despite a confirmation of purchase and a book entry or other indication that the security is part of a fungible bulk held for customers and despite the customer’s acquisition of a proportionate property interest in the fungible bulk.

(3) “Attornment” is the acknowledgment of a person in possession of a security that he holds the security for or on behalf of the purchaser.19

Although significant style and structure changes were made to the former section 30, paragraph (1)(b) of Fourth Draft section 26 left the first principle intact by affirmatively providing for delivery to a purchaser of specially indorsed and customer name securities in a broker’s possession.20 Likewise, the second principle, delivery by a broker’s identification of a “specific security,” was preserved. Indeed, for most purposes the story of the second principle can end here. The language of section 26(1)(c) is identical to the version of pre-1978 section 8-313(1)(c) that was eventually promulgated.21 Moreover, except for dealing with transfer (instead of delivery) and expanding the scope beyond brokers to embrace financial intermediaries, 1978 section 8-313(1)(d)(i) also made no substantive change.22 Although the 1978 version no longer provides the requisites of a delivery, it reaches the same result by providing that a transferee pursuant to 1978 section 8-313(d)(i) can become a bona fide purchaser.23 It follows that the interpretation given to delivery by identification of a “specific instrument” under the First Draft24 applies equally to identification of a “specific security” under pre-1978 section 8-313(1)(c) and 1978 section 8-313(1)(d)(i).25

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20 Fourth Draft, supra note 19, § 26(1)(b). Paragraph (1)(a), however, dropped any mention of the agency concept. Id., § 26(1)(a).
21 For discussions of the various official texts of the U.C.C., see infra notes 30-45 and accompanying text. Pre-1978 § 8-313(1)(c) remained unchanged through all of the various official texts of the U.C.C. until § 8-313 was substantially rewritten in the 1978 Article 8. Id.
23 U.C.C., §§ 8-302(1)(c), -313(2).
24 See supra notes 4-7 and accompanying text.
25 The subsequent pre-promulgation drafts, the notes to those drafts, the various promul-
The changes in style embodied in section 26 also preserved, without change in substance, the third principle, attornment only as to an "identified security," as well as the fourth principle, transfer of a property interest through a broker in the absence of a delivery. Section 27 of the fifth public draft was identical to section 26 of the Fourth Draft.

4. Subsequent Drafts Leading to 1952 Official Text

The Investment Securities article was first denominated Article 8 in the sixth public draft. The next six public drafts, culminating in the 1952 Official text, resulted in no material changes of substance in section 8-313 or the comment thereto. Thus, the four principles of the First Draft section 13 emerged in the 1952 Official Text, following a series of drafts spanning more than seven years, without dilution or change in substance.

Commenting on § 8-313 of the 1952 Official Text, it was observed:

[S]ubsection 1(b) merely describes an ordinary bailment situation, where the broker, acting as agent for a disclosed principal, has received, and holds, a security issued or indorsed to his principal. . . .

A similar situation occurs when the broker, by book entry . . . or otherwise . . . (physical segregation) . . . (tagging) identifies a particular security as belonging
5. 1962 and 1978 Official Texts

Section 8-313 was revised two more times, pursuant to the 1962 Official Text and the 1978 Official Text. The revision of section 8-

to the customer. It appears that, as far as it goes, subsection (1)(c) does not affect present law.

Subsection (1)(d) contemplates the situation where the selling broker, or some other person, appropriates the security for the customer with his assent. Since (1)(d) applies to specific, identified stock, title would pass, according to the presumed intent of the parties, at the time the offer to buy is accepted by the sending of the confirmation.

In subsection (2), however, the exclusionary effects of subsection (1) are set forth. It provides that unless the broker has a security indorsed to or issued in the customer's name, or identifies a specific security as belonging to the customer, the customer does not hold any specific security. In other words, there is no delivery of a security not indorsed to or issued in the customer's name unless the broker confirms the purchase order and picks a particular certificate.

The implication from Section 8-313(2) that the customer acquires a "property interest in fungible shares, even though he is not a holder of any particular certificate, may actually mean this: that title to the share passes immediately to the customer on notification, but delivery requires "earmarking". As suggested above, this is not a change in the law.


32 The text of and (with one exception) the comment to § 8-313 in the 1957 Official Text and the 1958 Official Text were identical to those in the 1952 Official Text. U.C.C., 1957 Official Text with Comments, § 8-313 & comment, reprinted in 20 Uniform Commercial Code Drafts, supra note 2, at 95-96; U.C.C., 1958 Official Text with Comments, § 8-313 & comment, reprinted in 21 Uniform Commercial Code Drafts, supra, at 347-48. The penultimate sentence of comment 3 to the 1957 Official was revised to state more directly that a customer can refuse to accept delivery from a broker when the customer receives notice of an adverse claim prior to delivery to the customer but after delivery to the broker. 1957 Official Text, supra, § 8-313 comment 3; see Supplement No. 1 to the 1952 Official Draft of Text and Comments of the U.C.C. 169-70 (January, 1955), reprinted in 17 Uniform Commercial Code Drafts, supra, at 487-88 (explaining this change to comment 3).


(2) The purchaser is the owner of a security held for him by his broker, but is not the holder except as specified in subparagraphs (b), (c) and (e) of subsection (1). Where a security is part of a fungible bulk the purchaser is the owner of a proportionate property interest in the fungible bulk.

1962 Official Text, supra, § 8-313(2), reprinted in 23 Uniform Commercial Code Drafts, supra, at 355. The new subsection (2) accommodated clearing corporation transfers under paragraph (1)(e) and anointed clearing corporation participant-transferees with holder status. The other
313 in the 1978 Article 8 changed its focus from that of delivery to an exclusive listing of means of transfer. Although it is clear that the drafters intended to preserve the four principles incorporated in the various pre-1978 versions of section 8-313, some of the wording of 1978 section 8-313 is less than felicitous in this connection.

As to the first principle, it remains the case that a transferee’s financial intermediary cannot be a “person designated” as used in paragraph (1)(a). The fourth principle, transfer of an interest in securities without a delivery, also is preserved. But the second and third principles have been obscured. The pre-1978 versions of paragraphs (1)(c) and (1)(d), as well as their Article V forbears, used the words “identify” and “identified” only in the context of identification of a “specific” security—a particular piece of paper. The 1978 section 8-313(1)(d) now also employs the concept of identification for the identification of quantities of securities in fungible bulk. This forces the word “specific” in paragraph (1)(d)(i) to shoulder the entire burden of providing that only a discrete piece of paper can be an identified specific security. Moreover, this drafting approach masks the meaning of the word “identified” in 1978 paragraph (1)(e)—the successor to pre-1978 paragraph 1(d)—which, properly construed, contemplates the same notion of a “specific” security. To make matters worse, 1978 principal change was the addition of affirmative statements of ownership by a broker’s customer who is not a holder in lieu of the mere implication of this result under the prior versions. However, the first sentence of the revised version should not be read to provide that a non-holder customer “owns” any particular security. Rather, the ownership of a non-holder customer in both sentences of the revised subsection (2) contemplate an ownership in a fungible bulk.


35 See supra, Part II, notes 77-83 and accompanying text.

36 See supra note 4. For this reason this Appendix does not deal with the various interim drafts that culminated in the 1978 Article 8.

37 Because only certain transfers can result in bona fide purchaser status under U.C.C. § 8-313(2) when a financial intermediary controls securities for a transferee, paragraph (1)(a) cannot be used to bootstrap such a transferee into receiving actual possession under agency principles. See U.C.C. §§ 8-302(1); -313(2).

38 U.C.C. §§ 8-313(1)(d)(ii) & (iii), -313(2) (first sentence). That transferees on interests in fungible bulks cannot become bona fide purchasers indicates that no delivery occurs.

39 See Aronstein, Security Interests in Securities: How Code Revision Reflects Modern Security-Holding Practices, 10 U.C.C. L.J. 289, 298 (1978) (“The requirements of a ‘specific security’ in paragraph (e) [of pre-1978 § 8-313(1)] and an ‘identified security’ in paragraph (d) rule out their application to situations where there is no particular piece of paper representing the rights to be transferred but where all other relevant considerations are identical.”) (emphasis added).

40 U.C.C. § 8-313(1)(d)(ii), (d)(iii).

41 See supra note 11 and accompanying text. U.C.C. § 8-313(1)(e), however, does not ap-
paragraph (1)(f) provides for transfer by a (non-financial intermediary) third person's acknowledgment "with respect to a specific uncertificated security." Finally, the change from a delivery-based section 8-313(1) makes it unclear whether a transferee of a specific identified security pursuant to paragraph (1)(e) receives a delivery so as to qualify for bona fide purchaser treatment. The 1978 section 8-302 Official Comment indicates that a transfer achieved by a non-financial intermediary third party acknowledgment, under 1978 section 8-313(1)(e), cannot confer bona fide purchaser status, but no reasons are given as to why a change was made from the result under pre-1978 section 8-313(1)(d).

To say the least, the language of 1978 section 8-313 is insensitive to the second and third principles that had survived so long through so many drafts and official texts. Hopefully the courts will honor the drafters' declared intent that the substance of prior law was preserved. Unfortunately, it is virtually impossible to read 1978 section 8-313 correctly without guidance from prior law and its drafting history.

\[\text{ply when the "third person" is a financial intermediary acting as such, unlike pre-1978 § 8-313(1)(d), which was not so limited (except that paragraph (1)(d) did not apply when the "third person" was the transferee's broker). See supra note 10 and accompanying text.} \]

\[\text{42 U.C.C. § 8-313(1)(f) (emphasis added). Martin Aronstein, the Reporter for the 1978 Article 8, has suggested to me that "specific" in paragraph (1)(f) is intended to limit its operation to circumstances where the uncertificated security registered to the third person can be traced to a particular initial transaction statement. Under this reading, a third person that is the registered owner of a large number of fungible uncertificated securities could not transfer an interest in a fractional portion thereof by acknowledgment to a transferee.} \]

\[\text{43 I t was clear under the pre-1978 version of § 8-313(1)(d) that a third person acknowledgment could result in a delivery and, therefore, bona fide purchaser treatment. See, e.g., pre-1978 § 8-313 comment 1 ("When the factual situations described in subsections (1)(b), (c) and (d) occur delivery to the purchaser is complete, and no intervening notice of adverse claims before he takes actual physical possession of the security can divest him of his rights."). Although the exceptions in pre-1978 § 8-313(2) addressed only deliveries under paragraphs (1)(b) and (c), not (1)(d), those exceptions applied only to purchasers whose securities were controlled by their broker. The acknowledging third person under pre-1978 paragraph (1)(d), of course, could not be the purchaser's broker. See supra note 10 and accompanying text.} \]

\[\text{44 See U.C.C. § 8-302, comment 2 ("[T]ransfers effected through the acknowledgment of a bailee who is not a financial intermediary . . . do not confer bona fide purchaser status."). The statement in the comment does not seem to follow from the language of the statute. The exceptions made in U.C.C. § 8-313(2) expressly allow bona fide purchaser status for certain transferees (pursuant to U.C.C. § 8-313(1)(c), (d)(i), and (g)) of securities controlled by financial intermediaries in fungible bulk. But U.C.C. § 8-313(2) says nothing about acknowledgments by non-financial intermediary bailees who are in possession of specific certificated securities as contemplated by U.C.C. § 8-313(1)(e).} \]

\[\text{45 See U.C.C., app. 1, § 8-313, Reasons for 1977 Change, at 977 (quoted in part supra note 4).} \]