

U.C.C. - ARTICLE 8 - INVESTMENT SECURITIES (REVISED 1994)

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[[Prefatory Note](#)]

PART 1. SHORT TITLE AND GENERAL MATTERS

§ 8-101. SHORT TITLE.

This Article may be cited as Uniform Commercial Code--Investment Securities.

§ 8-102. DEFINITIONS.

(a) In this Article:

- (1) "**Adverse claim**" means a claim that a claimant has a property interest in a [financial asset](#) and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset.
- (2) "**Bearer form**," as applied to a [certificated security](#), means a form in which the security is payable to the bearer of the [security certificate](#) according to its terms but not by reason of an [indorsement](#).

- (3) "**Broker**" means a person defined as a broker or dealer under the federal securities laws, but without excluding a bank acting in that capacity.
- (4) "**Certificated security**" means a security that is represented by a certificate.
- (5) "**Clearing corporation**" means:
- (i) a person that is registered as a "clearing agency" under the federal securities laws;
 - (ii) a federal reserve bank; or
 - (iii) any other person that provides clearance or settlement services with respect to [financial assets](#) that would require it to register as a clearing agency under the federal securities laws but for an exclusion or exemption from the registration requirement, if its activities as a clearing corporation, including promulgation of rules, are subject to regulation by a federal or state governmental authority.
- (6) "**Communicate**" means to:
- (i) send a signed writing; or
 - (ii) transmit information by any mechanism agreed upon by the persons transmitting and receiving the information.
- (7) "**Entitlement holder**" means a person identified in the records of a [securities intermediary](#) as the person having a [security entitlement](#) against the securities intermediary. If a person acquires a security entitlement by virtue of Section [8-501\(b\)\(2\) or \(3\)](#), that person is the entitlement holder.
- (8) "**Entitlement order**" means a notification [communicated](#) to a [securities intermediary](#) directing transfer or redemption of a [financial asset](#) to which the [entitlement holder](#) has a [security entitlement](#).
- (9) "**Financial asset**," except as otherwise provided in Section [8-103](#), means:
- (i) a security;
 - (ii) an obligation of a person or a share, participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on financial markets, or which is recognized in any area in which it is issued or dealt in as a medium for investment; or
 - (iii) any property that is held by a [securities intermediary](#) for another person in a [securities account](#) if the securities intermediary has expressly agreed with the other person that the property is to be treated as a [financial asset](#) under this Article.

As context requires, the term means either the interest itself or the means by which a person's claim to it is evidenced, including a certificated or [uncertificated security](#), a [security certificate](#), or a [security entitlement](#).

(10) [reserved]

(11) "**Indorsement**" means a signature that alone or accompanied by other words is made on a [security certificate](#) in [registered form](#) or on a separate document for the purpose of assigning, transferring, or redeeming the security or granting a power to assign, transfer, or redeem it.

(12) "**Instruction**" means a notification [communicated](#) to the [issuer](#) of an [uncertificated security](#) which directs that the transfer of the security be registered or that the security be redeemed.

(13) "**Registered form**," as applied to a certificated security, means a form in which:

- (i) the [security certificate](#) specifies a person entitled to the security; and
- (ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the [issuer](#), or the security certificate so states.

(14) "**Securities intermediary**" means:

- (i) a [clearing corporation](#); or
- (ii) a person, including a bank or [broker](#), that in the ordinary course of its business maintains [securities accounts](#) for others and is acting in that capacity.

(15) "**Security**," except as otherwise provided in Section [8-103](#), means an obligation of an [issuer](#) or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:

- (i) which is represented by a [security certificate](#) in [bearer](#) or [registered form](#), or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
- (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
- (iii) which:
 - (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
 - (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article.

(16) "**Security certificate**" means a certificate representing a security.

(17) "**Security entitlement**" means the rights and property interest of an [entitlement holder](#) with respect to a [financial asset](#) specified in Part 5.

(18) "**Uncertificated security**" means a security that is not represented by a certificate.

(b) Other definitions applying to this Article and the sections in which they appear are:

Appropriate person [§ 8-107](#)

Control [§ 8-106](#)

Delivery [§ 8-301](#)

Investment company security [§ 8-103](#)

Issuer [§ 8-201](#)

Overissue [§ 8-210](#)

Protected purchaser [§ 8-303](#)

Securities account [§ 8-501](#)

(c) In addition, Article 1 contains general definitions and principles of construction and interpretation applicable throughout this Article.

(d) The characterization of a person, business, or transaction for purposes of this Article does not determine the characterization of the person, business, or transaction for purposes of any other law, regulation, or rule.

[\[Comment\]](#)

§ 8-103. RULES FOR DETERMINING WHETHER CERTAIN OBLIGATIONS AND INTERESTS ARE SECURITIES OR FINANCIAL ASSETS.

(a) A share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity is a [security](#).

(b) An "**investment company security**" is a [security](#). "Investment company security" means a share or similar equity interest issued by an entity that is registered as an investment company under the federal investment company laws, an interest in a unit investment trust that is so registered, or a face-amount certificate issued by a face-amount certificate company that is so registered. Investment company security does not include an insurance policy or endowment policy or annuity contract issued by an insurance company.

(c) An interest in a partnership or limited liability company is not a [security](#) unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an [investment company security](#). However, an interest in a partnership or limited liability company is a [financial asset](#) if it is held in a [securities account](#).

(d) A writing that is a [security certificate](#) is governed by this Article and not by Article 3, even though it also meets the requirements of that Article. However, a negotiable instrument governed by Article 3 is a [financial asset](#) if it is held in a [securities account](#).

(e) An option or similar obligation issued by a [clearing corporation](#) to its participants is not a security, but is a [financial asset](#).

(f) A commodity contract, as defined in Section [9-102\(a\)\(15\)](#), is not a security or a [financial asset](#).

[[Comment](#)]

§ 8-104. ACQUISITION OF SECURITY OR FINANCIAL ASSET OR INTEREST THEREIN.

(a) A person acquires a [security](#) or an interest therein, under this Article, if:

(1) the person is a purchaser to whom a security is delivered pursuant to Section [8-301](#); or

(2) the person acquires a [security entitlement](#) to the security pursuant to Section [8-501](#).

(b) A person acquires a [financial asset](#), other than a [security](#), or an interest therein, under this Article, if the person acquires a [security entitlement](#) to the financial asset.

(c) A person who acquires a [security entitlement](#) to a [security](#) or other [financial asset](#) has the rights specified in Part 5, but is a purchaser of any security, security entitlement, or other financial asset held by the [securities intermediary](#) only to the extent provided in Section [8-503](#).

(d) Unless the context shows that a different meaning is intended, a person who is required by other law, regulation, rule, or agreement to transfer, deliver, present, surrender, exchange, or otherwise put in the possession of another person a [security](#) or [financial asset](#) satisfies that requirement by causing the other person to acquire an interest in the security or financial asset pursuant to subsection (a) or (b).

[[Comment](#)]

§ 8-105. NOTICE OF ADVERSE CLAIM.

(a) A person has **notice of an adverse claim** if:

- (1) the person knows of the adverse claim;
- (2) the person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim; or
- (3) the person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.

(b) Having knowledge that a [financial asset](#) or interest therein is or has been transferred by a representative imposes no duty of inquiry into the rightfulness of a transaction and is not notice of an [adverse claim](#). However, a person who knows that a representative has transferred a financial asset or interest therein in a transaction that is, or whose proceeds are being used, for the individual benefit of the representative or otherwise in breach of duty has notice of an adverse claim.

(c) An act or event that creates a right to immediate performance of the principal obligation represented by a [security certificate](#) or sets a date on or after which the certificate is to be presented or surrendered for redemption or exchange does not itself constitute notice of an [adverse claim](#) except in the case of a transfer more than:

- (1) one year after a date set for presentment or surrender for redemption or exchange; or
- (2) six months after a date set for payment of money against presentation or surrender of the certificate, if money was available for payment on that date.

(d) A purchaser of a certificated security has notice of an [adverse claim](#) if the [security certificate](#):

- (1) whether in [bearer](#) or [registered form](#), has been indorsed "for collection" or "for surrender" or for some other purpose not involving transfer; or
- (2) is in bearer form and has on it an unambiguous statement that it is the property of a person other than the transferor, but the mere writing of a name on the certificate is not such a statement.

(e) Filing of a financing statement under Article 9 is not notice of an [adverse claim](#) to a [financial asset](#).

[[Comment](#)]

§ 8-106. CONTROL.

(a) A purchaser has "**control**" of a certificated security in [bearer form](#) if the certificated security is delivered to the purchaser.

- (b) A purchaser has "control" of a certificated security in [registered form](#) if the certificated security is delivered to the purchaser, and:
- (1) the certificate is indorsed to the purchaser or in blank by an [effective indorsement](#); or
 - (2) the certificate is registered in the name of the purchaser, upon original issue or registration of transfer by the [issuer](#).
- (c) A purchaser has "control" of an [uncertificated security](#) if:
- (1) the uncertificated security is delivered to the purchaser; or
 - (2) the issuer has agreed that it will comply with [instructions](#) originated by the purchaser without further consent by the registered owner.
- (d) A purchaser has "control" of a [security entitlement](#) if:
- (1) the purchaser becomes the [entitlement holder](#); or
 - (2) the [securities intermediary](#) has agreed that it will comply with [entitlement orders](#) originated by the purchaser without further consent by the entitlement holder, or
 - (3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.
- (e) If an interest in a [security entitlement](#) is granted by the [entitlement holder](#) to the entitlement holder's own [securities intermediary](#), the securities intermediary has control.
- (f) A purchaser who has satisfied the requirements of subsection (c) or (d) has control even if the registered owner in the case of subsection (c) or the [entitlement holder](#) in the case of subsection (d) retains the right to make substitutions for the [uncertificated security](#) or [security entitlement](#), to originate [instructions](#) or [entitlement orders](#) to the [issuer](#) or [securities intermediary](#), or otherwise to deal with the uncertificated security or security entitlement.
- (g) An [issuer](#) or a [securities intermediary](#) may not enter into an agreement of the kind described in subsection (c)(2) or (d)(2) without the consent of the registered owner or [entitlement holder](#), but an issuer or a securities intermediary is not required to enter into such an agreement even though the registered owner or entitlement holder so directs. An issuer or securities intermediary that has entered into such an agreement is not required to confirm the existence of the agreement to another party unless requested to do so by the registered owner or entitlement holder.

[[Comment](#)]

§ 8-107. WHETHER INDORSEMENT, INSTRUCTION, OR ENTITLEMENT ORDER IS EFFECTIVE.

(a) "**Appropriate person**" means:

- (1) with respect to an [indorsement](#), the person specified by a [security certificate](#) or by an effective [special indorsement](#) to be entitled to the security;
- (2) with respect to an [instruction](#), the registered owner of an [uncertificated security](#);
- (3) with respect to an [entitlement order](#), the [entitlement holder](#);
- (4) if the person designated in paragraph (1), (2), or (3) is deceased, the designated person's successor taking under other law or the designated person's personal representative acting for the estate of the decedent; or
- (5) if the person designated in paragraph (1), (2), or (3) lacks capacity, the designated person's guardian, conservator, or other similar representative who has power under other law to transfer the security or [financial asset](#).

(b) An [indorsement](#), [instruction](#), or entitlement order is **effective** if:

- (1) it is made by the [appropriate person](#);
- (2) it is made by a person who has power under the law of agency to transfer the security or [financial asset](#) on behalf of the appropriate person, including, in the case of an [instruction](#) or [entitlement order](#), a person who has control under Section [8-106\(c\)\(2\)](#) or [\(d\)\(2\)](#); or
- (3) the appropriate person has ratified it or is otherwise precluded from asserting its ineffectiveness.

(c) An [indorsement](#), [instruction](#), or [entitlement order](#) made by a representative is effective even if:

- (1) the representative has failed to comply with a controlling instrument or with the law of the State having jurisdiction of the representative relationship, including any law requiring the representative to obtain court approval of the transaction; or
- (2) the representative's action in making the [indorsement](#), [instruction](#), or [entitlement order](#) or using the proceeds of the transaction is otherwise a breach of duty.

(d) If a security is registered in the name of or specially indorsed to a person described as a representative, or if a [securities account](#) is maintained in the name of a person described as a representative, an [indorsement](#), [instruction](#), or [entitlement order](#) made by the person is effective even though the person is no longer serving in the described capacity.

(e) Effectiveness of an [indorsement](#), [instruction](#), or [entitlement order](#) is determined as of the date the indorsement, instruction, or entitlement order is made, and an indorsement, instruction, or entitlement order does not become ineffective by reason of any later change of circumstances.

[[Comment](#)]

§ 8-108. WARRANTIES IN DIRECT HOLDING.

(a) A person who transfers a certificated security to a purchaser for value warrants to the purchaser, and an indorser, if the transfer is by [indorsement](#), warrants to any subsequent purchaser, that:

- (1) the certificate is genuine and has not been materially altered;
- (2) the transferor or indorser does not know of any fact that might impair the validity of the security;
- (3) there is no [adverse claim](#) to the security;
- (4) the transfer does not violate any restriction on transfer;
- (5) if the transfer is by [indorsement](#), the indorsement is made by an [appropriate person](#), or if the indorsement is by an agent, the agent has actual authority to act on behalf of the appropriate person; and
- (6) the transfer is otherwise [effective](#) and rightful.

(b) A person who originates an [instruction](#) for registration of transfer of an [uncertificated security](#) to a purchaser for value warrants to the purchaser that:

- (1) the instruction is made by an [appropriate person](#), or if the instruction is by an agent, the agent has actual authority to act on behalf of the appropriate person;
- (2) the security is valid;
- (3) there is no [adverse claim](#) to the security; and
- (4) at the time the instruction is presented to the [issuer](#):
 - (i) the purchaser will be entitled to the registration of transfer;
 - (ii) the transfer will be registered by the issuer free from all liens, security interests, restrictions, and claims other than those specified in the instruction;
 - (iii) the transfer will not violate any restriction on transfer; and
 - (iv) the requested transfer will otherwise be [effective](#) and rightful.

(c) A person who transfers an [uncertificated security](#) to a purchaser for value and does not originate an [instruction](#) in connection with the transfer warrants that:

- (1) the uncertificated security is valid;
- (2) there is no [adverse claim](#) to the security;
- (3) the transfer does not violate any restriction on transfer; and
- (4) the transfer is otherwise [effective](#) and rightful.

(d) A person who indorses a [security certificate](#) warrants to the [issuer](#) that:

- (1) there is no [adverse claim](#) to the security; and
- (2) the [indorsement](#) is [effective](#).

(e) A person who originates an [instruction](#) for registration of transfer of an [uncertificated security](#) warrants to the [issuer](#) that:

- (1) the instruction is [effective](#); and
- (2) at the time the instruction is presented to the issuer the purchaser will be entitled to the registration of transfer.

(f) A person who presents a certificated security for registration of transfer or for payment or exchange warrants to the [issuer](#) that the person is entitled to the registration, payment, or exchange, but a purchaser for value and without [notice of adverse claims](#) to whom transfer is registered warrants only that the person has no knowledge of any unauthorized signature in a necessary [indorsement](#).

(g) If a person acts as agent of another in delivering a certificated security to a purchaser, the identity of the principal was known to the person to whom the certificate was delivered, and the certificate delivered by the agent was received by the agent from the principal or received by the agent from another person at the direction of the principal, the person delivering the [security certificate](#) warrants only that the delivering person has authority to act for the principal and does not know of any [adverse claim](#) to the certificated security.

(h) A secured party who redelivers a [security certificate](#) received, or after payment and on order of the debtor delivers the security certificate to another person, makes only the warranties of an agent under subsection (g).

(i) Except as otherwise provided in subsection (g), a [broker](#) acting for a customer makes to the [issuer](#) and a purchaser the warranties provided in subsections (a) through (f). A broker that delivers a [security certificate](#) to its customer, or causes its customer to be registered as the owner of an [uncertificated security](#), makes to the customer the warranties provided in subsection (a) or (b), 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 the customer.

[[Comment](#)]

§ 8-109. WARRANTIES IN INDIRECT HOLDING.

(a) A person who originates an [entitlement order](#) to a [securities intermediary](#) warrants to the securities intermediary that:

(1) the [entitlement order](#) is made by an [appropriate person](#), or if the entitlement order is by an agent, the agent has actual authority to act on behalf of the appropriate person; and

(2) there is no [adverse claim](#) to the [security entitlement](#).

(b) A person who delivers a [security certificate](#) to a [securities intermediary](#) for credit to a [securities account](#) or originates an [instruction](#) with respect to an [uncertificated security](#) directing that the uncertificated security be credited to a securities account makes to the securities intermediary the warranties specified in Section [8-108\(a\)](#) or [\(b\)](#).

(c) If a [securities intermediary](#) delivers a [security certificate](#) to its [entitlement holder](#) or causes its entitlement holder to be registered as the owner of an [uncertificated security](#), the securities intermediary makes to the entitlement holder the warranties specified in Section [8-108\(a\)](#) or [\(b\)](#).

[[Comment](#)]

§ 8-110. APPLICABILITY; CHOICE OF LAW.

(a) The local law of the [issuer's](#) jurisdiction, as specified in subsection (d), governs:

(1) the validity of a security;

(2) the rights and duties of the issuer with respect to registration of transfer;

(3) the effectiveness of registration of transfer by the issuer;

(4) whether the issuer owes any duties to an adverse claimant to a security; and

(5) whether an [adverse claim](#) can be asserted against a person to whom transfer of a certificated or uncertificated security is registered or a person who obtains control of an uncertificated security.

(b) The local law of the securities intermediary's jurisdiction, as specified in subsection (e), governs:

(1) acquisition of a [security entitlement](#) from the [securities intermediary](#);

(2) the rights and duties of the securities intermediary and [entitlement holder](#) arising out of a security entitlement;

(3) whether the securities intermediary owes any duties to an adverse claimant to a security entitlement; and

(4) whether an [adverse claim](#) can be asserted against a person who acquires a security entitlement from the securities intermediary or a person who purchases a security entitlement or interest therein from an entitlement holder.

(c) The local law of the jurisdiction in which a [security certificate](#) is located at the time of [delivery](#) governs whether an [adverse claim](#) can be asserted against a person to whom the security certificate is delivered.

(d) "[Issuer's jurisdiction](#)" means the jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer. An issuer organized under the law of this State may specify the law of another jurisdiction as the law governing the matters specified in subsection (a)(2) through (5).

(e) The following rules determine a "[securities intermediary's jurisdiction](#)" for purposes of this section:

(1) If an agreement between the securities intermediary and its [entitlement holder](#) governing the securities account expressly provides that a particular jurisdiction is the securities intermediary's jurisdiction for purposes of this part, this article, or this act, that jurisdiction is the securities intermediary's jurisdiction.

(2) If paragraph (1) does not apply and an agreement between the securities intermediary and its entitlement holder expressly provides that the agreement is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

(3) If neither paragraph (i) nor paragraph (ii) applies and an agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that the [securities account](#) is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

(4) If none of the preceding paragraphs applies, the securities intermediary's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the entitlement holder's account is located.

(5) If none of the preceding paragraphs applies, the securities intermediary's jurisdiction is the jurisdiction in which the chief executive office of the securities intermediary is located.

(f) A [securities intermediary's jurisdiction](#) is not determined by the physical location of certificates representing [financial assets](#), or by the jurisdiction in which is organized the [issuer](#) of the financial asset with respect to which an [entitlement holder](#) has a [security entitlement](#), or by the location of facilities for data processing or other record keeping concerning the account.

[\[Comment\]](#)

§ 8-111. CLEARING CORPORATION RULES.

A rule adopted by a clearing corporation governing rights and obligations among the clearing corporation and its participants in the clearing corporation is [effective](#) even if the rule conflicts with this [Act] and affects another party who does not consent to the rule.

[\[Comment\]](#)

§ 8-112. CREDITOR'S LEGAL PROCESS.

(a) The interest of a debtor in a certificated security may be reached by a creditor only by actual seizure of the [security certificate](#) by the officer making the attachment or levy, except as otherwise provided in subsection (d). However, a certificated security for which the certificate has been surrendered to the [issuer](#) may be reached by a creditor by legal process upon the issuer.

(b) The interest of a debtor in an [uncertificated security](#) may be reached by a creditor only by legal process upon the [issuer](#) at its chief executive office in the United States, except as otherwise provided in subsection (d).

(c) The interest of a debtor in a [security entitlement](#) may be reached by a creditor only by legal process upon the [securities intermediary](#) with whom the debtor's [securities account](#) is maintained, except as otherwise provided in subsection (d).

(d) The interest of a debtor in a certificated security for which the certificate is in the possession of a secured party, or in an [uncertificated security](#) registered in the name of a secured party, or a [security entitlement](#) maintained in the name of a secured party, may be reached by a creditor by legal process upon the secured party.

(e) A creditor whose debtor is the owner of a certificated security, [uncertificated security](#), or [security entitlement](#) is entitled to aid from a court of competent jurisdiction, by injunction or otherwise, in reaching the certificated security, uncertificated security, or security entitlement or in satisfying the claim by means allowed at law or in equity in regard to property that cannot readily be reached by other legal process.

[\[Comment\]](#)

§ 8-113. STATUTE OF FRAUDS INAPPLICABLE.

A contract or modification of a contract for the sale or purchase of a [security](#) is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making.

[\[Comment\]](#)

§ 8-114. EVIDENTIARY RULES CONCERNING CERTIFICATED SECURITIES.

The following rules apply in an action on a [certificated security](#) against the [issuer](#):

- (1) Unless specifically denied in the pleadings, each signature on a [security certificate](#) or in a necessary [indorsement](#) is admitted.
- (2) If the effectiveness of a signature is put in issue, the burden of establishing effectiveness is on the party claiming under the signature, but the signature is presumed to be genuine or authorized.
- (3) If signatures on a security certificate are admitted or established, production of the certificate entitles a holder to recover on it unless the defendant establishes a defense or a defect going to the validity of the security.
- (4) If it is shown that a defense or defect exists, the plaintiff has the burden of establishing that the plaintiff or some person under whom the plaintiff claims is a person against whom the defense or defect cannot be asserted.

[[Comment](#)]

§ 8-115. SECURITIES INTERMEDIARY AND OTHERS NOT LIABLE TO ADVERSE CLAIMANT.

A [securities intermediary](#) that has transferred a [financial asset](#) pursuant to an [effective entitlement order](#), or a [broker](#) or other agent or bailee that has dealt with a financial asset at the direction of its customer or principal, is not liable to a person having an [adverse claim](#) to the financial asset, unless the securities intermediary, or broker or other agent or bailee:

- (1) took the action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order, or other legal process; or
- (2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or
- (3) in the case of a security certificate that has been stolen, acted with [notice of the adverse claim](#).

[[Comment](#)]

§ 8-116. SECURITIES INTERMEDIARY AS PURCHASER FOR VALUE.

A [securities intermediary](#) that receives a [financial asset](#) and establishes a [security entitlement](#) to the financial asset in favor of an [entitlement holder](#) is a purchaser for

value of the financial asset. A securities intermediary that acquires a security entitlement to a financial asset from another securities intermediary acquires the security entitlement for value if the securities intermediary acquiring the security entitlement establishes a security entitlement to the financial asset in favor of an entitlement holder.

[[Comment](#)]

PART 2. ISSUE AND ISSUER

§ 8-201. ISSUER.

(a) With respect to an obligation on or a defense to a security, an "**issuer**" includes a person that:

(1) places or authorizes the placing of its name on a [security certificate](#), other than as authenticating trustee, registrar, transfer agent, or the like, to evidence a share, participation, or other interest in its property or in an enterprise, or to evidence its duty to perform an obligation represented by the certificate;

(2) creates a share, participation, or other interest in its property or in an enterprise, or undertakes an obligation, that is an [uncertificated security](#);

(3) directly or indirectly creates a fractional interest in its rights or property, if the fractional interest is represented by a security certificate; or

(4) becomes responsible for, or in place of, another person described as an issuer in this section.

(b) With respect to an obligation on or defense to a security, a guarantor is an [issuer](#) to the extent of its guaranty, whether or not its obligation is noted on a [security certificate](#).

(c) With respect to a registration of a transfer, [issuer](#) means a person on whose behalf transfer books are maintained.

[[Comment](#)]

§ 8-202. ISSUER'S RESPONSIBILITY AND DEFENSES; NOTICE OF DEFECT OR DEFENSE.

(a) Even against a purchaser for value and without notice, the terms of a certificated security include terms stated on the certificate and terms made part of the security by reference on the certificate to another instrument, indenture, or document or to a constitution, statute, ordinance, rule, regulation, order, or the like, to the extent the terms referred to do not conflict with terms stated on the certificate. A reference under this subsection does not of itself charge a purchaser for value with notice of a defect going to the validity of the security, even if the certificate expressly states that a person accepting it admits notice. The terms of an [uncertificated security](#) include those stated in any instrument, indenture, or

document or in a constitution, statute, ordinance, rule, regulation, order, or the like, pursuant to which the security is issued.

(b) The following rules apply if an [issuer](#) asserts that a security is not valid:

(1) A security other than one issued by a government or governmental subdivision, agency, or instrumentality, even though issued with a defect going to its validity, is valid in the hands of a purchaser for value and without notice of the particular defect unless the defect involves a violation of a constitutional provision. In that case, the security is valid in the hands of a purchaser for value and without notice of the defect, other than one who takes by original issue.

(2) Paragraph (1) applies to an issuer that is a government or governmental subdivision, agency, or instrumentality only if there has been substantial compliance with the legal requirements governing the issue or the issuer has received a substantial consideration for the issue as a whole or for the particular security and a stated purpose of the issue is one for which the issuer has power to borrow money or issue the security.

(c) Except as otherwise provided in Section [8-205](#), lack of genuineness of a certificated security is a complete defense, even against a purchaser for value and without notice.

(d) All other defenses of the [issuer](#) of a security, including nondelivery and conditional [delivery](#) of a certificated security, are ineffective against a purchaser for value who has taken the certificated security without notice of the particular defense.

(e) This section does not affect the right of a party to cancel a contract for a security "when, as and if issued" or "when distributed" in the event of a material change in the character of the security that is the subject of the contract or in the plan or arrangement pursuant to which the security is to be issued or distributed.

(f) If a security is held by a [securities intermediary](#) against whom an [entitlement holder](#) has a [security entitlement](#) with respect to the security, the [issuer](#) may not assert any defense that the issuer could not assert if the entitlement holder held the security directly.

[[Comment](#)]

§ 8-203. STALENESS AS NOTICE OF DEFECT OR DEFENSE.

After an act or event, other than a call that has been revoked, creating a right to immediate performance of the principal obligation represented by a certificated security or setting a date on or after which the security is to be presented or surrendered for redemption or exchange, a purchaser is charged with notice of any defect in its issue or defense of the [issuer](#), if the act or event:

(1) requires the payment of money, the [delivery](#) of a certificated security, the registration of transfer of an [uncertificated security](#), or any of them on

presentation or surrender of the [security certificate](#), the money or security is available on the date set for payment or exchange, and the purchaser takes the security more than one year after that date; or

(2) is not covered by paragraph (1) and the purchaser takes the security more than two years after the date set for surrender or presentation or the date on which performance became due.

[[Comment](#)]

§ 8-204. EFFECT OF ISSUER'S RESTRICTION ON TRANSFER.

A restriction on transfer of a security imposed by the [issuer](#), even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless:

(1) the security is certificated and the restriction is noted conspicuously on the [security certificate](#); or

(2) the security is uncertificated and the registered owner has been notified of the restriction.

[[Comment](#)]

§ 8-205. EFFECT OF UNAUTHORIZED SIGNATURE ON SECURITY CERTIFICATE.

An unauthorized signature placed on a [security certificate](#) before or in the course of issue is ineffective, but the signature is [effective](#) in favor of a purchaser for value of the certificated security if the purchaser is without notice of the lack of authority and the signing has been done by:

(1) an authenticating trustee, registrar, transfer agent, or other person entrusted by the [issuer](#) with the signing of the security certificate or of similar security certificates, or the immediate preparation for signing of any of them; or

(2) an employee of the issuer, or of any of the persons listed in paragraph (1), entrusted with responsible handling of the security certificate.

[[Comment](#)]

§ 8-206. COMPLETION OR ALTERATION OF SECURITY CERTIFICATE.

(a) If a [security certificate](#) contains the signatures necessary to its issue or transfer but is incomplete in any other respect:

(1) any person may complete it by filling in the blanks as authorized; and

(2) even if the blanks are incorrectly filled in, the security certificate as completed is enforceable by a purchaser who took it for value and without notice of the incorrectness.

(b) A complete [security certificate](#) that has been improperly altered, even if fraudulently, remains enforceable, but only according to its original terms.

[[Comment](#)]

§ 8-207. RIGHTS AND DUTIES OF ISSUER WITH RESPECT TO REGISTERED OWNERS.

(a) Before due presentment for registration of transfer of a certificated security in [registered form](#) or of an [instruction](#) requesting registration of transfer of an [uncertificated security](#), the [issuer](#) or indenture trustee may treat the registered owner as the person exclusively entitled to vote, receive notifications, and otherwise exercise all the rights and powers of an owner.

(b) This Article does not affect the liability of the registered owner of a security for a call, assessment, or the like.

[[Comment](#)]

§ 8-208. EFFECT OF SIGNATURE OF AUTHENTICATING TRUSTEE, REGISTRAR, OR TRANSFER AGENT.

(a) A person signing a [security certificate](#) as authenticating trustee, registrar, transfer agent, or the like, warrants to a purchaser for value of the certificated security, if the purchaser is without notice of a particular defect, that:

(1) the certificate is genuine;

(2) the person's own participation in the issue of the security is within the person's capacity and within the scope of the authority received by the person from the [issuer](#); and

(3) the person has reasonable grounds to believe that the certificated security is in the form and within the amount the issuer is authorized to issue.

(b) Unless otherwise agreed, a person signing under subsection (a) does not assume responsibility for the validity of the security in other respects.

[[Comment](#)]

§ 8-209. ISSUER'S LIEN.

A lien in favor of an [issuer](#) upon a certificated security is valid against a purchaser only if the right of the issuer to the lien is noted conspicuously on the [security certificate](#).

[\[Comment\]](#)

§ 8-210. OVERISSUE.

(a) In this section, "**overissue**" means the issue of securities in excess of the amount the [issuer](#) has corporate power to issue, but an overissue does not occur if appropriate action has cured the overissue.

(b) Except as otherwise provided in subsections (c) and (d), the provisions of this Article which validate a security or compel its issue or reissue do not apply to the extent that validation, issue, or reissue would result in [overissue](#).

(c) If an identical security not constituting an [overissue](#) is reasonably available for purchase, a person entitled to issue or validation may compel the [issuer](#) to purchase the security and deliver it if certificated or register its transfer if uncertificated, against surrender of any [security certificate](#) the person holds.

(d) If a security is not reasonably available for purchase, a person entitled to issue or validation may recover from the [issuer](#) the price the person or the last purchaser for value paid for it with interest from the date of the person's demand.

[\[Comment\]](#)

PART 3. TRANSFER OF CERTIFICATED AND UNCERTIFICATED SECURITIES

§ 8-301. DELIVERY.

(a) **Delivery** of a certificated security to a purchaser occurs when:

(1) the purchaser acquires possession of the [security certificate](#);

(2) another person, other than a [securities intermediary](#), either acquires possession of the security certificate on behalf of the purchaser or, having previously acquired possession of the certificate, acknowledges that it holds for the purchaser; or

(3) a securities intermediary acting on behalf of the purchaser acquires possession of the security certificate, only if the certificate is in [registered form](#) and is (i) registered in the name of the purchaser, (ii) payable to the order of the purchaser, or (iii) specially indorsed to the purchaser by an [effective indorsement](#) and has not been indorsed to the securities intermediary or in blank.

(b) Delivery of an [uncertificated security](#) to a purchaser occurs when:

(1) the [issuer](#) registers the purchaser as the registered owner, upon original issue or registration of transfer; or

(2) another person, other than a [securities intermediary](#), either becomes the registered owner of the uncertificated security on behalf of the purchaser or, having previously become the registered owner, acknowledges that it holds for the purchaser.

[[Comment](#)]

§ 8-302. RIGHTS OF PURCHASER.

(a) Except as otherwise provided in subsections (b) and (c), a purchaser of a [certificated](#) or [uncertificated security](#) acquires all rights in the security that the transferor had or had power to transfer.

(b) A purchaser of a limited interest acquires rights only to the extent of the interest purchased.

(c) A purchaser of a certificated security who as a previous holder had [notice of an adverse claim](#) does not improve its position by taking from a [protected purchaser](#).

[[Comment](#)]

§ 8-303. PROTECTED PURCHASER.

(a) "**Protected purchaser**" means a purchaser of a certificated or [uncertificated security](#), or of an interest therein, who:

(1) gives value;

(2) does not have [notice of any adverse claim](#) to the security; and

(3) obtains control of the certificated or [uncertificated security](#).

(b) In addition to acquiring the rights of a purchaser, a [protected purchaser](#) also acquires its interest in the security free of any [adverse claim](#).

[[Comment](#)]

§ 8-304. INDORSEMENT.

(a) An [indorsement](#) may be in blank or special. An indorsement in blank includes an indorsement to bearer. A **special indorsement** specifies to whom a security is to be transferred or who has power to transfer it. A holder may convert a blank indorsement to a special indorsement.

(b) An [indorsement](#) purporting to be only of part of a [security certificate](#) representing units intended by the [issuer](#) to be separately transferable is [effective](#) to the extent of the indorsement.

(c) An [indorsement](#), whether special or in blank, does not constitute a transfer until [delivery](#) of the certificate on which it appears or, if the indorsement is on a separate document, until delivery of both the document and the certificate.

(d) If a [security certificate](#) in [registered form](#) has been delivered to a purchaser without a necessary [indorsement](#), the purchaser may become a [protected purchaser](#) only when the indorsement is supplied. However, against a transferor, a transfer is complete upon [delivery](#) and the purchaser has a specifically enforceable right to have any necessary indorsement supplied.

(e) An [indorsement](#) of a [security certificate](#) in [bearer form](#) may give [notice of an adverse claim](#) to the certificate, but it does not otherwise affect a right to registration that the holder possesses.

(f) Unless otherwise agreed, a person making an [indorsement](#) assumes only the obligations provided in Section [8-108](#) and not an obligation that the security will be honored by the [issuer](#).

[\[Comment\]](#)

§ 8-305. INSTRUCTION.

(a) If an [instruction](#) has been originated by an [appropriate person](#) but is incomplete in any other respect, any person may complete it as authorized and the [issuer](#) may rely on it as completed, even though it has been completed incorrectly.

(b) Unless otherwise agreed, a person initiating an [instruction](#) assumes only the obligations imposed by Section [8-108](#) and not an obligation that the [security](#) will be honored by the [issuer](#).

[\[Comment\]](#)

§ 8-306. EFFECT OF GUARANTEEING SIGNATURE, INDORSEMENT, OR INSTRUCTION.

(a) A person who guarantees a signature of an indorser of a [security certificate](#) warrants that at the time of signing:

(1) the signature was genuine;

(2) the signer was an [appropriate person](#) to indorse, or if the signature is by an agent, the agent had actual authority to act on behalf of the appropriate person; and

(3) the signer had legal capacity to sign.

(b) A person who guarantees a signature of the originator of an [instruction](#) warrants that at the time of signing:

(1) the signature was genuine;

(2) the signer was an [appropriate person](#) to originate the instruction, or if the signature is by an agent, the agent had actual authority to act on behalf of the appropriate person, if the person specified in the instruction as the registered owner was, in fact, the registered owner, as to which fact the signature guarantor does not make a warranty; and

(3) the signer had legal capacity to sign.

(c) A person who specially guarantees the signature of an originator of an [instruction](#) makes the warranties of a signature guarantor under subsection (b) and also warrants that at the time the instruction is presented to the [issuer](#):

(1) the person specified in the instruction as the registered owner of the [uncertificated security](#) will be the registered owner; and

(2) the transfer of the uncertificated security requested in the instruction will be registered by the issuer free from all liens, security interests, restrictions, and claims other than those specified in the instruction.

(d) A guarantor under subsections (a) and (b) or a special guarantor under subsection (c) does not otherwise warrant the rightfulness of the transfer.

(e) A person who guarantees an [indorsement](#) of a [security certificate](#) makes the warranties of a signature guarantor under subsection (a) and also warrants the rightfulness of the transfer in all respects.

(f) A person who guarantees an [instruction](#) requesting the transfer of an [uncertificated security](#) makes the warranties of a special signature guarantor under subsection (c) and also warrants the rightfulness of the transfer in all respects.

(g) An [issuer](#) may not require a special guaranty of signature, a guaranty of [indorsement](#), or a guaranty of [instruction](#) as a condition to registration of transfer.

(h) The warranties under this section are made to a person taking or dealing with the security in reliance on the guaranty, and the guarantor is liable to the person for loss resulting from their breach. An indorser or originator of an [instruction](#) whose signature, [indorsement](#), or instruction has been guaranteed is liable to a guarantor for any loss suffered by the guarantor as a result of breach of the warranties of the guarantor.

[\[Comment\]](#)

§ 8-307. PURCHASER'S RIGHT TO REQUISITES FOR REGISTRATION OF TRANSFER.

Unless otherwise agreed, the transferor of a [security](#) on due demand shall supply the purchaser with proof of authority to transfer or with any other requisite necessary to obtain registration of the transfer of the security, but if the transfer is not for value, a transferor need not comply unless the purchaser pays the necessary expenses. If

the transferor fails within a reasonable time to comply with the demand, the purchaser may reject or rescind the transfer.

[[Comment](#)]

PART 4. REGISTRATION

§ 8-401. DUTY OF ISSUER TO REGISTER TRANSFER.

(a) If a certificated security in [registered form](#) is presented to an [issuer](#) with a request to register transfer or an [instruction](#) is presented to an issuer with a request to register transfer of an [uncertificated security](#), the issuer shall register the transfer as requested if:

- (1) under the terms of the security the person seeking registration of transfer is eligible to have the security registered in its name;
- (2) the [indorsement](#) or instruction is made by the [appropriate person](#) or by an agent who has actual authority to act on behalf of the appropriate person;
- (3) reasonable assurance is given that the [indorsement](#) or instruction is genuine and authorized (Section [8-402](#));
- (4) any applicable law relating to the collection of taxes has been complied with;
- (5) the transfer does not violate any restriction on transfer imposed by the [issuer](#) in accordance with Section [8-204](#);
- (6) a demand that the issuer not register transfer has not become [effective](#) under Section [8-403](#), or the issuer has complied with Section [8-403\(b\)](#) but no legal process or indemnity bond is obtained as provided in Section [8-403\(d\)](#); and
- (7) the transfer is in fact rightful or is to a [protected purchaser](#).

(b) If an [issuer](#) is under a duty to register a transfer of a security, the issuer is liable to a person presenting a certificated security or an [instruction](#) for registration or to the person's principal for loss resulting from unreasonable delay in registration or failure or refusal to register the transfer.

[[Comment](#)]

§ 8-402. ASSURANCE THAT INDORSEMENT OR INSTRUCTION IS EFFECTIVE.

(a) An [issuer](#) may require the following assurance that each necessary [indorsement](#) or each [instruction](#) is genuine and authorized:

(1) in all cases, a guaranty of the signature of the person making an [indorsement](#) or originating an instruction including, in the case of an instruction, reasonable assurance of identity;

(2) if the [indorsement](#) is made or the instruction is originated by an agent, appropriate assurance of actual authority to sign;

(3) if the [indorsement](#) is made or the instruction is originated by a fiduciary pursuant to Section [8-107\(a\)\(4\) or \(a\)\(5\)](#), appropriate evidence of appointment or incumbency;

(4) if there is more than one fiduciary, reasonable assurance that all who are required to sign have done so; and

(5) if the [indorsement](#) is made or the instruction is originated by a person not covered by another provision of this subsection, assurance appropriate to the case corresponding as nearly as may be to the provisions of this subsection.

(b) An [issuer](#) may elect to require reasonable assurance beyond that specified in this section.

(c) In this section:

(1) "Guaranty of the signature" means a guaranty signed by or on behalf of a person reasonably believed by the [issuer](#) to be responsible. An issuer may adopt standards with respect to responsibility if they are not manifestly unreasonable.

(2) "Appropriate evidence of appointment or incumbency" means:

(i) in the case of a fiduciary appointed or qualified by a court, a certificate issued by or under the direction or supervision of the court or an officer thereof and dated within 60 days before the date of presentation for transfer; or

(ii) in any other case, a copy of a document showing the appointment or a certificate issued by or on behalf of a person reasonably believed by an [issuer](#) to be responsible or, in the absence of that document or certificate, other evidence the issuer reasonably considers appropriate.

[\[Comment\]](#)

§ 8-403. DEMAND THAT ISSUER NOT REGISTER TRANSFER.

(a) A person who is an [appropriate person](#) to make an [indorsement](#) or originate an [instruction](#) may demand that the [issuer](#) not register transfer of a security by communicating to the issuer a notification that identifies the registered owner and the issue of which the security is a part and provides an address for communications directed to the person making the demand. The demand is [effective](#) only if it is received by the issuer at a time and in a manner affording the issuer reasonable opportunity to act on it.

(b) If a certificated security in [registered form](#) is presented to an [issuer](#) with a request to register transfer or an [instruction](#) is presented to an issuer with a request to register transfer of an [uncertificated security](#) after a demand that the issuer not register transfer has become [effective](#), the issuer shall promptly [communicate](#) to (i) the person who initiated the demand at the address provided in the demand and (ii) the person who presented the security for registration of transfer or initiated the instruction requesting registration of transfer a notification stating that:

(1) the certificated security has been presented for registration of transfer or the instruction for registration of transfer of the uncertificated security has been received;

(2) a demand that the issuer not register transfer had previously been received; and

(3) the issuer will withhold registration of transfer for a period of time stated in the notification in order to provide the person who initiated the demand an opportunity to obtain legal process or an indemnity bond.

(c) The period described in subsection (b)(3) may not exceed 30 days after the date of communication of the notification. A shorter period may be specified by the [issuer](#) if it is not manifestly unreasonable.

(d) An [issuer](#) is not liable to a person who initiated a demand that the issuer not register transfer for any loss the person suffers as a result of registration of a transfer pursuant to an [effective indorsement](#) or [instruction](#) if the person who initiated the demand does not, within the time stated in the issuer's communication, either:

(1) obtain an appropriate restraining order, injunction, or other process from a court of competent jurisdiction enjoining the issuer from registering the transfer; or

(2) file with the issuer an indemnity bond, sufficient in the issuer's judgment to protect the issuer and any transfer agent, registrar, or other agent of the issuer involved from any loss it or they may suffer by refusing to register the transfer.

(e) This section does not relieve an [issuer](#) from liability for registering transfer pursuant to an [indorsement](#) or [instruction](#) that was not [effective](#).

[[Comment](#)]

§ 8-404. WRONGFUL REGISTRATION.

(a) Except as otherwise provided in Section [8-406](#), an [issuer](#) is liable for wrongful registration of transfer if the issuer has registered a transfer of a security to a person not entitled to it, and the transfer was registered:

(1) pursuant to an ineffective [indorsement](#) or [instruction](#);

(2) after a demand that the issuer not register transfer became [effective](#) under Section [8-403\(a\)](#) and the issuer did not comply with Section [8-403\(b\)](#);

(3) after the issuer had been served with an injunction, restraining order, or other legal process enjoining it from registering the transfer, issued by a court of competent jurisdiction, and the issuer had a reasonable opportunity to act on the injunction, restraining order, or other legal process; or

(4) by an issuer acting in collusion with the wrongdoer.

(b) An [issuer](#) that is liable for wrongful registration of transfer under subsection (a) on demand shall provide the person entitled to the security with a like certificated or [uncertificated security](#), and any payments or distributions that the person did not receive as a result of the wrongful registration. If an [overissue](#) would result, the issuer's liability to provide the person with a like security is governed by Section [8-210](#).

(c) Except as otherwise provided in subsection (a) or in a law relating to the collection of taxes, an [issuer](#) is not liable to an owner or other person suffering loss as a result of the registration of a transfer of a security if registration was made pursuant to an [effective indorsement](#) or [instruction](#).

[\[Comment\]](#)

§ 8-405. REPLACEMENT OF LOST, DESTROYED, OR WRONGFULLY TAKEN SECURITY CERTIFICATE.

(a) If an owner of a certificated security, whether in [registered](#) or [bearer form](#), claims that the certificate has been lost, destroyed, or wrongfully taken, the [issuer](#) shall issue a new certificate if the owner:

(1) so requests before the issuer has notice that the certificate has been acquired by a [protected purchaser](#);

(2) files with the issuer a sufficient indemnity bond; and

(3) satisfies other reasonable requirements imposed by the issuer.

(b) If, after the issue of a new [security certificate](#), a [protected purchaser](#) of the original certificate presents it for registration of transfer, the [issuer](#) shall register the transfer unless an [overissue](#) would result. In that case, the issuer's liability is governed by Section [8-210](#). In addition to any rights on the indemnity bond, an issuer may recover the new certificate from a person to whom it was issued or any person taking under that person, except a protected purchaser.

[\[Comment\]](#)

§ 8-406. OBLIGATION TO NOTIFY ISSUER OF LOST, DESTROYED, OR WRONGFULLY TAKEN SECURITY CERTIFICATE.

If a [security certificate](#) has been lost, apparently destroyed, or wrongfully taken, and the owner fails to notify the [issuer](#) of that fact within a reasonable time after the owner has notice of it and the issuer registers a transfer of the security before receiving notification, the owner may not assert against the issuer a claim for registering the transfer under Section [8-404](#) or a claim to a new security certificate under Section [8-405](#).

[[Comment](#)]

§ 8-407. AUTHENTICATING TRUSTEE, TRANSFER AGENT, AND REGISTRAR.

A person acting as authenticating trustee, transfer agent, registrar, or other agent for an [issuer](#) in the registration of a transfer of its securities, in the issue of new [security certificates](#) or [uncertificated securities](#), or in the cancellation of surrendered security certificates has the same obligation to the holder or owner of a certificated or uncertificated security with regard to the particular functions performed as the issuer has in regard to those functions.

[[Comment](#)]

PART 5. SECURITY ENTITLEMENTS

§ 8-501. SECURITIES ACCOUNT; ACQUISITION OF SECURITY ENTITLEMENT FROM SECURITIES INTERMEDIARY.

(a) "**Securities account**" means an account to which a [financial asset](#) is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.

(b) Except as otherwise provided in subsections (d) and (e), a person acquires a [security entitlement](#) if a [securities intermediary](#):

(1) indicates by book entry that a [financial asset](#) has been credited to the person's securities account;

(2) receives a [financial asset](#) from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person's securities account;
or

(3) becomes obligated under other law, regulation, or rule to credit a [financial asset](#) to the person's securities account.

(c) If a condition of subsection (b) has been met, a person has a [security entitlement](#) even though the [securities intermediary](#) does not itself hold the [financial asset](#).

(d) If a [securities intermediary](#) holds a [financial asset](#) for another person, and the financial asset is registered in the name of, payable to the order of, or specially indorsed to the other person, and has not been indorsed to the securities intermediary or in blank, the other person is treated as holding the financial asset directly rather than as having a [security entitlement](#) with respect to the financial asset.

(e) Issuance of a security is not establishment of a [security entitlement](#).

[[Comment](#)]

§ 8-502. ASSERTION OF ADVERSE CLAIM AGAINST ENTITLEMENT HOLDER.

An action based on an [adverse claim](#) to a [financial asset](#), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a [security entitlement](#) under Section [8-501](#) for value and without [notice of the adverse claim](#).

[[Comment](#)]

§ 8-503. PROPERTY INTEREST OF ENTITLEMENT HOLDER IN FINANCIAL ASSET HELD BY SECURITIES INTERMEDIARY.

(a) To the extent necessary for a [securities intermediary](#) to satisfy all security entitlements with respect to a particular [financial asset](#), all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the [entitlement holders](#), are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section [8-511](#).

(b) An [entitlement holder's](#) property interest with respect to a particular [financial asset](#) under subsection (a) is a pro rata property interest in all interests in that financial asset held by the [securities intermediary](#), without regard to the time the entitlement holder acquired the [security entitlement](#) or the time the securities intermediary acquired the interest in that financial asset.

(c) An entitlement holder's property interest with respect to a particular [financial asset](#) under subsection (a) may be enforced against the [securities intermediary](#) only by exercise of the entitlement holder's rights under Sections [8-505 through 8-508](#).

(d) An [entitlement holder's](#) property interest with respect to a particular [financial asset](#) under subsection (a) may be enforced against a purchaser of the financial asset or interest therein only if:

- (1) insolvency proceedings have been initiated by or against the [securities intermediary](#);
- (2) the securities intermediary does not have sufficient interests in the [financial asset](#) to satisfy the security entitlements of all of its [entitlement holders](#) to that financial asset;
- (3) the securities intermediary violated its obligations under Section [8-504](#) by transferring the [financial asset](#) or interest therein to the purchaser; and
- (4) the purchaser is not protected under subsection (e).

The trustee or other liquidator, acting on behalf of all [entitlement holders](#) having security entitlements with respect to a particular [financial asset](#), may recover the financial asset, or interest therein, from the purchaser. If the trustee or other liquidator elects not to pursue that right, an entitlement holder whose [security entitlement](#) remains unsatisfied has the right to recover its interest in the financial asset from the purchaser.

(e) An action based on the [entitlement holder's](#) property interest with respect to a particular [financial asset](#) under subsection (a), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the [securities intermediary](#) in violating the securities intermediary's obligations under Section [8-504](#).

[[Comment](#)]

§ 8-504. DUTY OF SECURITIES INTERMEDIARY TO MAINTAIN FINANCIAL ASSET.

(a) A [securities intermediary](#) shall promptly obtain and thereafter maintain a [financial asset](#) in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its [entitlement holders](#) with respect to that financial asset. The securities intermediary may maintain those financial assets directly or through one or more other securities intermediaries.

(b) Except to the extent otherwise agreed by its [entitlement holder](#), a [securities intermediary](#) may not grant any security interests in a [financial asset](#) it is obligated to maintain pursuant to subsection (a).

(c) A [securities intermediary](#) satisfies the duty in subsection (a) if:

- (1) the securities intermediary acts with respect to the duty as agreed upon by the [entitlement holder](#) and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary exercises due care in accordance with reasonable commercial standards to obtain and maintain the [financial asset](#).

(d) This section does not apply to a [clearing corporation](#) that is itself the obligor of an option or similar obligation to which its [entitlement holders](#) have security entitlements.

[[Comment](#)]

§ 8-505. DUTY OF SECURITIES INTERMEDIARY WITH RESPECT TO PAYMENTS AND DISTRIBUTIONS.

(a) A [securities intermediary](#) shall take action to obtain a payment or distribution made by the [issuer](#) of a [financial asset](#). A securities intermediary satisfies the duty if:

(1) the securities intermediary acts with respect to the duty as agreed upon by the [entitlement holder](#) and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary exercises due care in accordance with reasonable commercial standards to attempt to obtain the payment or distribution.

(b) A [securities intermediary](#) is obligated to its [entitlement holder](#) for a payment or distribution made by the [issuer](#) of a [financial asset](#) if the payment or distribution is received by the securities intermediary.

[[Comment](#)]

§ 8-506. DUTY OF SECURITIES INTERMEDIARY TO EXERCISE RIGHTS AS DIRECTED BY ENTITLEMENT HOLDER.

A [securities intermediary](#) shall exercise rights with respect to a [financial asset](#) if directed to do so by an [entitlement holder](#). A securities intermediary satisfies the duty if:

(1) the securities intermediary acts with respect to the duty as agreed upon by the entitlement holder and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary either places the entitlement holder in a position to exercise the rights directly or exercises due care in accordance with reasonable commercial standards to follow the direction of the entitlement holder.

[[Comment](#)]

§ 8-507. DUTY OF SECURITIES INTERMEDIARY TO COMPLY WITH ENTITLEMENT ORDER.

(a) A [securities intermediary](#) shall comply with an [entitlement order](#) if the entitlement order is originated by the [appropriate person](#), the securities intermediary has had reasonable opportunity to assure itself that the entitlement order is genuine and authorized, and the securities intermediary has had reasonable opportunity to comply with the entitlement order. A securities intermediary satisfies the duty if:

(1) the securities intermediary acts with respect to the duty as agreed upon by the [entitlement holder](#) and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary exercises due care in accordance with reasonable commercial standards to comply with the [entitlement order](#).

(b) If a [securities intermediary](#) transfers a [financial asset](#) pursuant to an ineffective [entitlement order](#), the securities intermediary shall reestablish a [security entitlement](#) in favor of the person entitled to it, and pay or credit any payments or distributions that the person did not receive as a result of the wrongful transfer. If the securities intermediary does not reestablish a security entitlement, the securities intermediary is liable to the [entitlement holder](#) for damages.

[[Comment](#)]

§ 8-508. DUTY OF SECURITIES INTERMEDIARY TO CHANGE ENTITLEMENT HOLDER'S POSITION TO OTHER FORM OF SECURITY HOLDING.

A [securities intermediary](#) shall act at the direction of an [entitlement holder](#) to change a [security entitlement](#) into another available form of holding for which the entitlement holder is eligible, or to cause the [financial asset](#) to be transferred to a [securities account](#) of the entitlement holder with another securities intermediary. A securities intermediary satisfies the duty if:

(1) the securities intermediary acts as agreed upon by the [entitlement holder](#) and the securities intermediary; or

(2) in the absence of agreement, the securities intermediary exercises due care in accordance with reasonable commercial standards to follow the direction of the entitlement holder.

[[Comment](#)]

§ 8-509. SPECIFICATION OF DUTIES OF SECURITIES INTERMEDIARY BY OTHER STATUTE OR REGULATION; MANNER OF PERFORMANCE OF DUTIES OF SECURITIES

INTERMEDIARY AND EXERCISE OF RIGHTS OF ENTITLEMENT HOLDER.

- (a) If the substance of a duty imposed upon a [securities intermediary](#) by [Sections 8-504 through 8-508](#) is the subject of other statute, regulation, or rule, compliance with that statute, regulation, or rule satisfies the duty.
- (b) To the extent that specific standards for the performance of the duties of a [securities intermediary](#) or the exercise of the rights of an [entitlement holder](#) are not specified by other statute, regulation, or rule or by agreement between the securities intermediary and entitlement holder, the securities intermediary shall perform its duties and the entitlement holder shall exercise its rights in a commercially reasonable manner.
- (c) The obligation of a [securities intermediary](#) to perform the duties imposed by [Sections 8-504 through 8-508](#) is subject to:
- (1) rights of the securities intermediary arising out of a security interest under a security agreement with the [entitlement holder](#) or otherwise; and
 - (2) rights of the securities intermediary under other law, regulation, rule, or agreement to withhold performance of its duties as a result of unfulfilled obligations of the [entitlement holder](#) to the securities intermediary.
- (d) [Sections 8-504 through 8-508](#) do not require a [securities intermediary](#) to take any action that is prohibited by other statute, regulation, or rule.

[[Comment](#)]

§ 8-510. RIGHTS OF PURCHASER OF SECURITY ENTITLEMENT FROM ENTITLEMENT HOLDER.

- (a) In a case not covered by the priority rules in Article 9 or the rules stated in subsection (c), an action based on an [adverse claim](#) to a [financial asset](#) or [security entitlement](#), whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who purchases a security entitlement, or an interest therein, from an [entitlement holder](#) if the purchaser gives value, does not have [notice of the adverse claim](#), and obtains control.
- (b) If an [adverse claim](#) could not have been asserted against an [entitlement holder](#) under Section [8-502](#), the adverse claim cannot be asserted against a person who purchases a [security entitlement](#), or an interest therein, from the entitlement holder.
- (c) In a case not covered by the priority rules in Article 9, a purchaser for value of a [security entitlement](#), or an interest therein, who obtains control has priority over a purchaser of a security entitlement, or an interest therein, who does not obtain control. Except as otherwise provided in subsection (d), purchasers who have control rank according to priority in time of:

(1) the purchaser's becoming the person for whom the securities account, in which the security entitlement is carried, is maintained, if the purchaser obtained control under Section [8-106\(d\)\(1\)](#);

(2) the securities intermediary's agreement to comply with the purchaser's entitlement orders with respect to security entitlements carried or to be carried in the securities account in which the security entitlement is carried, if the purchaser obtained control under Section [8-106\(d\)\(2\)](#); or

(3) if the purchaser obtained control through another person under Section [8-106\(d\)\(3\)](#), the time on which priority would be based under this subsection if the other person were the secured party.

(d) A [securities intermediary](#) as purchaser has priority over a conflicting purchaser who has control unless otherwise agreed by the securities intermediary.

[[Comment](#)]

§ 8-511. PRIORITY AMONG SECURITY INTERESTS AND ENTITLEMENT HOLDERS.

(a) Except as otherwise provided in subsections (b) and (c), if a [securities intermediary](#) does not have sufficient interests in a particular [financial asset](#) to satisfy both its obligations to [entitlement holders](#) who have security entitlements to that financial asset and its obligation to a creditor of the securities intermediary who has a security interest in that financial asset, the claims of entitlement holders, other than the creditor, have priority over the claim of the creditor.

(b) A claim of a creditor of a [securities intermediary](#) who has a security interest in a [financial asset](#) held by a securities intermediary has priority over claims of the securities intermediary's [entitlement holders](#) who have security entitlements with respect to that financial asset if the creditor has control over the financial asset.

(c) If a [clearing corporation](#) does not have sufficient [financial assets](#) to satisfy both its obligations to [entitlement holders](#) who have security entitlements with respect to a financial asset and its obligation to a creditor of the clearing corporation who has a security interest in that financial asset, the claim of the creditor has priority over the claims of entitlement holders.

[[Comment](#)]

PART 6. TRANSITION PROVISIONS FOR REVISED ARTICLE 8 AND CONFORMING AMENDMENTS TO ARTICLES 1, 4, 5, 9, AND 10

§ 8-601. EFFECTIVE DATE.

[This \[Act\] takes effect](#)

§ 8-602. REPEALS.

[This \[Act\] repeals](#)

[\[Comment\]](#)

§ 8-603. SAVINGS CLAUSE.

(a) This [Act] does not affect an action or proceeding commenced before this [Act] takes effect.

(b) If a security interest in a [security](#) is perfected at the date this [Act] takes effect, and the action by which the security interest was perfected would suffice to perfect a security interest under this [Act], no further action is required to continue perfection. If a security interest in a security is perfected at the date this [Act] takes effect but the action by which the security interest was perfected would not suffice to perfect a security interest under this [Act], the security interest remains perfected for a period of four months after the effective date and continues perfected thereafter if appropriate action to perfect under this [Act] is taken within that period. If a security interest is perfected at the date this [Act] takes effect and the security interest can be perfected by filing under this [Act], a financing statement signed by the secured party instead of the debtor may be filed within that period to continue perfection or thereafter to perfect.

[\[Comment\]](#)

PREFATORY NOTE - 1994 REVISION

The present version of Article 8 is the product of a major revision made necessary by the fact that the prior version of Article 8 did not adequately deal with the system of securities holding through securities intermediaries that has developed in the past few decades. Although the prior version of Article 8 did contain some provisions dealing with securities holding through securities intermediaries, these were engrafted onto a structure designed for securities practices of earlier times. The resulting legal uncertainties adversely affected all participants. The revision is intended to eliminate these uncertainties by providing a modern legal structure for current securities holding practices.

I. EVOLUTION OF SECURITIES HOLDING SYSTEMS

A. The Traditional Securities Holding System

The original version of Article 8, drafted in the 1940s and 1950s, was based on the assumption that possession and delivery of physical certificates are the key elements in the securities holding system. Ownership of securities was

traditionally evidenced by possession of the certificates, and changes were accomplished by delivery of the certificates.

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

B. The Uncertificated Securities System Envisioned by the 1978 Amendments

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

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

C. Evolution of the Indirect Holding System

At the time of the "paperwork crunch" in the late 1960s, the trading volume on the New York Stock Exchange that so seriously strained the capacities of the clearance and settlement system was in the range of 10 million shares per day. Today, the system can easily handle trading volume on routine days of hundreds

of millions of shares. This processing capacity could have been achieved only by the application of modern electronic information processing systems. Yet the legal rules under which the system operates are *not* the uncertificated securities provisions of Article 8. To understand why this is so, one must delve at least a bit deeper into the operations of the current system.

If one examines the shareholder records of large corporations whose shares are publicly traded on the exchanges or in the over the counter market, one would find that one entity -- Cede & Co. -- is listed as the shareholder of record of somewhere in the range of sixty to eighty per cent of the outstanding shares of all publicly traded companies. Cede & Co. is the nominee name used by The Depository Trust Company ("DTC"), a limited purpose trust company organized under New York law for the purpose of acting as a depository to hold securities for the benefit of its participants, some 600 or so broker-dealers and banks. Essentially all of the trading in publicly held companies is executed through the broker-dealers who are participants in DTC, and the great bulk of public securities -- the sixty to eighty per cent figure noted above -- are held by these broker-dealers and banks on behalf of their customers. If all of these broker-dealers and banks held physical certificates, then as trades were executed each day it would be necessary to deliver the certificates back and forth among these broker-dealers and banks. By handing all of their securities over to a common depository all of these deliveries can be eliminated. Transfers can be accomplished by adjustments to the participants' DTC accounts.

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

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

an enormous number of trades, yet it is possible that relatively little of this trading activity will result in any net change in the custodian bank's positions on the books of DTC.

Settlement of market trading in most of the major U.S. securities markets is now effected primarily through some form of netted clearance and depository system. Virtually all publicly traded corporate equity securities, corporate debt securities, and municipal debt securities are now eligible for deposit in the DTC system. Recently, DTC has implemented a similar depository settlement system for the commercial paper market, and could, but for limitations in present Article 8, handle other forms of short-term money market securities such as bankers' acceptances. For trading in mortgage-backed securities, such as Ginnie Mae's, a similar depository settlement system has been developed by Participants Trust Company. For trading in U.S. Treasury securities, a somewhat analogous book-entry system is operated under Treasury rules by the Federal Reserve System.

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

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

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

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

The principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but netted settlement arrangements and accounting entries on the books of a multi-

tiered pyramid of securities intermediaries. Herein is the basic problem. Virtually all of the rules of the prior version of Article 8 specifying how changes in ownership of securities are effected, and what happens if something goes awry in the process, were keyed to the concepts of a transfer of physical certificates or registration of transfers on the books of the issuers, yet that is not how changes in ownership are actually reflected in the modern securities holding system.

II. BRIEF OVERVIEW OF REVISED ARTICLE 8

A. Drafting Approach -- Neutrality Principle

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

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

Revised Article 8 takes a neutral position on the evolution of securities holding practices. The revision was based on the assumption that the path of development will be determined by market and regulatory forces and that the Article 8 rules should not seek to influence that development in any specific direction. Although various drafting approaches were considered, it became apparent early in the revision process that the differences between the direct holding system and the indirect holding system are sufficiently significant that it

is best to treat them as separate systems requiring different legal concepts. Accordingly, while the rules of the prior version of Article 8 have, in large measure, been retained for the direct holding system, a new Part 5 has been added, setting out the commercial law rules for the indirect securities holding system. The principle of neutrality does carry some implications for the design of specific Article 8 rules. At the very least, the Article 8 rules for all securities holding systems should be sufficiently clear and predictable that uncertainty about the governing law does not itself operate as a constraint on market developments. In addition, an effort has been made to identify and eliminate any Article 8 rules that might act as impediments to any of the foreseeable paths of development.

B. Direct Holding System

With respect to securities held directly, Revised Article 8 retains the basic conceptual structure and rules of present law. Part 2, which is largely unchanged from former law, deals with certain aspects of the obligations of issuers. The primary purpose of the rules of Part 2 is to apply to investment securities the principles of negotiable instruments law that preclude the issuers of negotiable instruments from asserting defenses against subsequent purchasers. Part 3 deals with transfer for securities held directly. One of its principal purposes is to apply to investment securities the principles of negotiable instruments law that protect purchasers of negotiable instruments against adverse claims. Part 4 deals with the process of registration of transfer by the issuer or transfer agent.

Although the basic concepts of the direct holding system rules have been retained, there are significant changes in terminology, organization, and statement of the rules. Some of the major changes are as follows:

Simplification of Part 3. The addition of the new Part 5 on the indirect holding system makes unnecessary the rather elaborate provisions of former law, such as those in Section 8-313, that sought to fit the indirect holding system into the conceptual structure of the direct holding system. Thus, Part 3 of Revised Article 8 is, in many respects, more similar to the original version of Article 8 than to the 1978 version.

Protected purchaser. The prior version of Article 8 used the term "bona fide purchaser" to refer to those purchasers who took free from adverse claims, and it used the phrase "good faith" in stating the requirements for such status. In order to promote clarity, Revised Article 8 states the rules that protect purchasers against adverse claims without using the phrase "good faith" and uses the new term "protected purchaser" to refer to purchasers in the direct holding system who are protected against adverse claims. See Sections [8-105](#) and [8-303](#).

Certificated versus uncertificated securities. The rules of the 1978 version of Article 8 concerning uncertificated securities have been simplified considerably. The 1978 version added provisions on uncertificated securities parallel to the provisions of the original version of Article 8 dealing with securities represented by certificates. Thus, virtually every section had one set of rules on "certificated securities" and another on "uncertificated securities." The constant juxtaposition of "certificated securities" and "uncertificated

securities" has probably led readers to overemphasize the differences. Revised Article 8 has a unitary definition of "security" in Section [8-102\(a\)\(15\)](#) which refers to the underlying intangible interest or obligation. In Revised Article 8, the difference between certificated and uncertificated is treated not as an inherent attribute of the security but as a difference in the means by which ownership is evidenced. The terms "certificated" and "uncertificated" security are used in those sections where it is important to distinguish between these two means of evidencing ownership. Revised Article 8 also deletes the provisions of the 1978 version concerning "transaction statements" and "registered pledges." These changes are explained in the Revision Notes [3](#), [4](#), and [5](#), below.

Scope of Parts 2, 3, and 4. The rules of Parts 2, 3, and 4 deal only with the rights of persons who hold securities directly. In typical securities holding arrangements in the modern depository system, only the clearing corporation would be a direct holder of the securities. Thus, while the rules of Parts 2, 3, and 4 would apply to the relationship between the issuer and the clearing corporation, they have no application to relationships below the clearing corporation level. Under Revised Article 8, a person who holds a security through a broker or securities custodian has a security entitlement governed by the Part 5 rules but is not the direct holder of the security. Thus, the rules of Revised Section [8-303](#) on the rights of "protected purchasers," which are the analog of the bona fide purchaser rules of former Article 8, do not apply to persons who hold securities through brokers or securities custodians. Instead, Part 5 contains its own rules to protect investors in the indirect holding system against adverse claims. See Revised Section [8-502](#).

C. Indirect Holding System

Although the Revised Article 8 provisions for the indirect holding system are somewhat complex, the basic approach taken can be summarized rather briefly. Revised Article 8 abandons the attempt to describe all of the complex relationships in the indirect holding system using the simple concepts of the traditional direct holding system. Instead, new rules specifically designed for the indirect holding system are added as Part 5 of Article 8. In a nutshell, the approach is to describe the core of the package of rights of a person who holds a security through a securities intermediary and then give that package of rights a name.

The starting point of Revised Article 8's treatment of the indirect holding system is the concept of "security entitlement." The term is defined in Section [8-102\(a\)\(17\)](#) as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5." Like many legal concepts, however, the meaning of "security entitlement" is to be found less in any specific definition than in the matrix of rules that use the term. In a sense, then, the entirety of Part 5 is the definition of "security entitlement" because the Part 5 rules specify the rights and property interest that comprise a security entitlement.

Part 5 begins by specifying, in Section [8-501](#), when an entitlement holder acquires a security entitlement. The basic rule is very simple. A person acquires a security entitlement when the securities intermediary credits the financial asset

to the person's account. The remaining sections of Part 5 specify the content of the security entitlement concept. Section [8-504](#) provides that a securities intermediary must maintain a sufficient quantity of financial assets to satisfy the claims of all of its entitlement holders. Section [8-503](#) provides that these financial assets are held by the intermediary for the entitlement holders, are not the property of the securities intermediary, and are not subject to claims of the intermediary's general creditors. Thus, a security entitlement is itself a form of property interest not merely an *in personam* claim against the intermediary. The concept of a security entitlement does, however, include a package of *in personam* rights against the intermediary. Other Part 5 rules identify the core of this package of rights, subject to specification by agreement and regulatory law. See Sections [8-505 through 8-509](#).

To illustrate the basic features of the new rules, consider a simple example of two investors, John and Mary, each of whom owns 1000 shares of Acme, Inc., a publicly traded company. John has a certificate representing his 1000 shares and is registered on the books maintained by Acme's transfer agent as the holder of record of those 1000 shares. Accordingly, he has a direct claim against the issuer, he receives dividends and distributions directly from the issuer, and he receives proxies directly from the issuer for purposes of voting his shares. Mary has chosen to hold her securities through her broker. She does not have a certificate and is not registered on Acme's stock books as a holder of record. She enjoys the economic and corporate benefits of ownership but does so through her broker and any other intermediaries in the chain back to the issuer. John's interest in Acme common stock would be described under Revised Article 8 as a direct interest in a "security." Thus, if John grants a security interest in his investment position, the collateral would be described as a "security." Mary's interest in Acme common stock would be described under Revised Article 8 as a "security entitlement." Thus, if Mary grants a security interest in her investment position, the collateral would be described as a "security entitlement."

For many purposes, there is no need to differentiate among the various ways that an investor might hold securities. For example, for purposes of financial accounting, John and Mary would each be described as the owner of 1000 shares of Acme common stock. For those purposes it is irrelevant that John is the registered owner and has physical possession of a certificate, while Mary holds her position through an intermediary. Revised Article 8 recognizes this point in Section 8-104 which provides that acquiring a security entitlement and acquiring a security certificate are different ways of acquiring an interest in the underlying security.

D. Security Interests

Along with the revision of Article 8, significant changes have been made in the rules concerning security interests in securities. The revision returns to the pre-1978 structure in which the rules on security interests in investment securities are set out in Article 9, rather than in Article 8. The changes in Article 9 are, in part, conforming changes to adapt Article 9 to the new concept of a security entitlement. The Article 9 changes, however, go beyond that to establish a simplified structure for the creation and perfection of security interests in investment securities, whether held directly or indirectly.

The Revised Article 9 rules continue the long-established principle that a security interest in a security represented by a certificate can be perfected by a possessory pledge. The revised rules, however, do not require that all security interests in investment securities be implemented by procedures based on the conceptual structure of the common law pledge. Under the revised Article 9 rules, a security interest in securities can be created pursuant to Section [9-203](#) in the same fashion as a security interest in any other form of property, that is, by agreement between the debtor and secured party. There is no requirement of a "transfer," "delivery," or any similar action, physical or metaphysical, for the creation of an effective security interest. A security interest in securities is, of course, a form of property interest, but the only requirements for creation of this form of property interest are those set out in Section [9-203](#).

The perfection methods for security interests in investment securities are set out in Sections [9-309](#), [9-312](#), [9-313](#), and [9-314](#). The basic rule is that a security interest may be perfected by "control." The concept of control, defined in Section [8-106](#), plays an important role in both Article 8 and Article 9. In general, obtaining control means taking the steps necessary to place the lender in a position where it can have the collateral sold off without the further cooperation of the debtor. Thus, for certificated securities, a lender obtains control by taking possession of the certificate with any necessary indorsement. For securities held through a securities intermediary, the lender can obtain control in two ways. First, the lender obtains control if it becomes the entitlement holder; that is, has the securities positions transferred to an account in its own name. Second, the lender obtains control if the securities intermediary agrees to act on instructions from the secured party to dispose of the positions, even though the debtor remains the entitlement holder. Such an arrangement suffices to give the lender control even though the debtor retains the right to trade and exercise other ordinary rights of an entitlement holder.

Except where the debtor is itself a securities firm, filing of an ordinary Article 9 financing statement is also a permissible alternative method of perfection. However, filing with respect to investment property does not assure the lender the same protections as for other forms of collateral, since the priority rules provide that a secured party who obtains control has priority over a secured party who does not obtain control.

The details of the new rules on security interests, as applied both to the retail level and to arrangements for secured financing of securities dealers, are explained in the Official Comments to Sections [9-309](#), [9-312](#), [9-313](#), and [9-314](#).

III. SCOPE AND APPLICATION OF ARTICLE 8

A. Terminology

To understand the scope and application of the rules of Revised Article 8, and the related security interest rules of Article 9, it is necessary to understand some of the key defined terms:

Security, defined in Section [8-102\(a\)\(15\)](#), has essentially the same meaning as under the prior version of Article 8. The difference in Revised Article 8 is

that the definition of security does not determine the coverage of all of Article 8. Although the direct holding system rules in Parts 2, 3, and 4 apply only to securities, the indirect holding system rules of Part 5 apply to the broader category of "financial assets."

Financial asset, defined in Section [8-103\(a\)\(9\)](#), is the term used to describe the forms of property to which the indirect holding system rules of Part 5 apply. The term includes not only "securities," but also other interests, obligations, or property that are held through securities accounts. The best illustration of the broader scope of the term financial asset is the treatment of money market instruments, discussed below.

Security entitlement, defined in Section [8-103\(a\)\(17\)](#), is the term used to describe the property interest of a person who holds a security or other financial asset through a securities intermediary.

Securities intermediary, defined in Section [8-103\(a\)\(14\)](#), is the term used for those who hold securities for others in the indirect holding system. It covers clearing corporations, banks acting as securities custodians, and brokers holding securities for their customers.

Entitlement holder, defined in Section [8-103\(a\)\(7\)](#), is the term used for those who hold securities through intermediaries.

Securities account, defined in Section [8-501\(a\)](#), describes the form of arrangement between a securities intermediary and an entitlement holder that gives rise to a security entitlement. As explained below, the definition of securities account plays a key role in setting the scope of the indirect holding system rules of Part 5.

Investment property, defined in Section [9-102\(a\)\(49\)](#), determines the application of the new Article 9 rules for secured transactions. In addition to securities and security entitlements, the Article 9 term "investment property" is defined to include "securities account" in order to simplify the drafting of the Article 9 rules that permit debtors to grant security interests either in specific security entitlements or in an entire securities account. The other difference between the coverage of the Article 8 and Article 9 terms is that commodity futures contracts are excluded from Article 8, but are included within the Article 9 definition of "investment property." Thus, the new Article 9 rules apply to security interests in commodity futures positions as well as security interests in securities positions.

B. Notes on Scope of Article 8

Article 8 is in no sense a comprehensive codification of the law governing securities or transactions in securities. Although Article 8 deals with some aspects of the rights of securities holders against issuers, most of that relationship is governed not by Article 8, but by corporation, securities, and contract law. Although Article 8 deals with some aspects of the rights and duties of parties who transfer securities, it is not a codification of the law of contracts for the purchase or sale of securities. (The prior version of Article 8 did include a

few miscellaneous rules on contracts for the sale of securities, but these have not been included in Revised Article 8). Although the new indirect holding system rules of Part 5 deal with some aspects of the relationship between brokers or other securities professionals and their customers, Article 8 is still not in any sense a comprehensive code of the law governing the relationship between broker-dealers or other securities intermediaries and their customers. Most of the law governing that relationship is the common law of contract and agency, supplemented or supplanted by regulatory law.

The distinction between the aspects of the broker-customer relationship that are and are not dealt with in this Article may be illuminated by considering the differing roles of the broker in a typical securities transaction, in which the broker acts as agent for the customer. When a customer directs a broker to buy or sell securities for the customer, and the broker executes that trade on a securities exchange or in the over the counter market, the broker is entering into a contract for the purchase or sale of the securities as agent of the customer. The rules of the exchange, practices of the market, or regulatory law will specify when and how that contract is to be performed. For example, today the terms of the standard contract for trades in most corporate securities require the seller to deliver the securities, and the buyer to pay for them, five business days after the date that the contract was made, although the SEC has recently promulgated a rule that will accelerate the cycle to require settlement in three business days. In the common speech of the industry, the transaction in which the broker enters into a contract for the purchase or sale of the securities is referred to as executing the trade, and the transaction in which the securities are delivered and paid for is referred to as settlement. Thus, the current settlement cycle is known as T+5, that is, settlement is required on the fifth business day after the date of the trade, and the new SEC rule will change it to T+3. One must be careful in moving from the jargon of the securities industry to the jargon of the legal profession. For most practical economic purposes, the trade date is the date that counts, because that is the time at which the price is set, the risk of price changes shifts, and the parties become bound to perform. For purposes of precise legal analysis, however, the securities phrase "trade" or "execute a trade" means enter into a contract for the purchase or sale of the securities. The transfer of property interests occurs not at the time the contract is made but at the time it is performed, that is, at settlement.

The distinction between trade and settlement is important in understanding the scope of Article 8. Article 8 deals with the settlement phase of securities transactions. It deals with the mechanisms by which interests in securities are transferred, and the rights and duties of those who are involved in the transfer process. It does not deal with the process of entering into contracts for the transfer of securities or regulate the rights and duties of those involved in the contracting process. To use securities parlance, Article 8 deals not with the trade, but with settlement of the trade. Indeed, Article 8 does not even deal with all aspects of settlement. In a netted clearance and settlement system such as the NSCC-DTC system, individual trades are not settled one-by-one by corresponding entries on the books of any depository. Rather, settlement of the individual trades occurs through the clearing arrangements, in accordance with the rules and agreements that govern those arrangements.

In the rules dealing with the indirect holding system, one must be particularly careful to bear in mind the distinction between trade and settlement. Under Revised Article 8, the property interest of a person who holds securities through an intermediary is described as a "security entitlement," which is defined in Revised Section 8-102(a)(17) as the package of rights and property interest of an entitlement holder specified in Part 5. Saying that the security entitlement is a package of rights against the broker does not mean that all of the customer's rights against the broker are part of the security entitlement and hence part of the subject matter of Article 8. The distinction between trade and settlement remains fundamental. The rules of this Article on the indirect holding system deal with brokers and other intermediaries as media through which investors hold their financial assets. Brokers are also media through which investors buy and sell their financial assets, but that aspect of their role is not the subject of this Article.

The principal goal of the Article 8 revision project is to provide a satisfactory framework for analysis of the indirect holding system. The technique used in Revised Article 8 is to acknowledge explicitly that the relationship between a securities intermediary and its entitlement holders is *sui generis*, and to state the applicable commercial law rules directly, rather than by inference from a categorization of the relationship based on legal concepts of a different era. One of the consequences of this drafting technique is that in order to provide content to the concept of security entitlement it becomes necessary to identify the core of the package of rights that make up a security entitlement. Sections [8-504 through 8-508](#) cover such basic matters as the duty of the securities intermediary to maintain a sufficient quantity of securities to satisfy all of its entitlement holders, the duty of the securities intermediary to pass through to entitlement holder the economic and corporate law rights of ownership of the security, and the duty of the securities intermediary to comply with authorized entitlement orders originated by the entitlement holder. These sections are best thought of as definitional; that is, a relationship which does not include these rights is not the kind of relationship that Revised Article 8 deals with. Because these sections take the form of statements of the duties of an intermediary toward its entitlement holders, one must be careful to avoid a distorted perspective on what Revised Article 8 is and is not designed to do. Revised Article 8 is not, and should not be, a comprehensive body of private law governing the relationship between brokers and their customers, nor a body of regulatory law to police against improper conduct by brokers or other intermediaries. Many, if not most, aspects of the relationship between brokers and customers are governed by the common law of contract and agency, supplemented or supplanted by federal and state regulatory law. Revised Article 8 does not take the place of this body of private and regulatory law. If there are gaps in the regulatory law, they should be dealt with as such; Article 8 is not the place to address them. Article 8 deals with how interests in securities are evidenced and how they are transferred. By way of a rough analogy, one might think of Article 8 as playing the role for the securities markets that real estate recording acts play for the real estate markets. Real estate recording acts do not regulate the conduct of parties to real estate transactions; Article 8 does not regulate the conduct of parties to securities transactions.

C. Application of Revised Articles 8 and 9 to Common Investments and Investment Arrangements

It may aid understanding to sketch briefly the treatment under Revised Articles 8 and 9 of a variety of relatively common products and arrangements.

1. Publicly traded stocks and bonds.

"Security" is defined in Revised Section [8-102\(a\)\(15\)](#) in substantially the same terms as in the prior version of Article 8. It covers the ordinary publicly traded investment securities, such as corporate stocks and bonds. Parts 2, 3, and 4 govern the interests of persons who hold securities directly, and Part 5 governs the interest of those who hold securities indirectly.

Ordinary publicly traded securities provide a good illustration of the relationship between the direct and indirect holding system rules. The distinction between the direct and indirect holding systems is not an attribute of the securities themselves but of the way in which a particular person holds the securities. Thus, whether one looks to the direct holding system rules of Parts 2, 3, and 4 or the indirect holding system rules of Part 5 will depend on the level in the securities holding system being analyzed.

Consider, for example, corporate stock which is held through a depository, such as DTC. The clearing corporation, or its nominee, is the registered owner of all of the securities it holds on behalf of all of its participants. Thus the rules of Parts 2, 3, and 4 of Revised Article 8 apply to the relationship between the issuer and the clearing corporation. If, as is typically the case today, the securities are still represented by certificates, the clearing corporation will be the holder of the security certificate or certificates representing its total holdings. So far as Article 8 is concerned, the relationship between the issuer and the clearing corporation is no different from the relationship between the issuer and any other registered owner.

The relationship between the clearing corporation and its participants is governed by the indirect holding system rules of Part 5. At that level, the clearing corporation is the securities intermediary and the participant is the entitlement holder. If the participant is itself a securities intermediary, such as a broker holding for its customers or a bank acting as a securities custodian, the Part 5 rules apply to its relationship to its own customers. At that level the broker or bank custodian is the securities intermediary and the customer is the entitlement holder. Note that the broker or bank custodian is both an entitlement holder and a securities intermediary -- but is so with respect to different security entitlements. For purposes of Article 8 analysis, the customer's security entitlement against the broker or bank custodian is a different item of property from the security entitlement of the broker or bank custodian against the clearing corporation.

For investors who hold their securities directly, it makes no difference that some other investors hold their interests indirectly. Many investors today choose to hold their securities directly, becoming the registered owners on the books of the issuer and obtaining certificates registered in their names. For such investors, the addition of the new indirect holding system rules to Article 8 is entirely irrelevant. They will continue to deal directly with the issuers, or their transfer agents, under essentially the same rules as in the prior version of Article 8.

The securities holding options available to investors in a particular form of security may depend on the terms of the security. For example, direct holding is frequently not available for new issues of state and local government bonds. At one time, state and local government bonds were commonly issued in bearer form. Today, however, new issues of state and local government bonds must be in registered form and most are issued in what is known as "book-entry only" form; that is, the issuer specifies that the only person it will directly register as the registered owner is a clearing corporation. Thus, one of the inherent terms of the security is that investors can hold only in the indirect holding system.

2. Treasury securities.

U.S. government securities fall within the definition of security in Article 8 and therefore are governed by Article 8 in the same fashion as any other publicly held debt security, except insofar as Article 8 is preempted by applicable federal law or regulation.

New Treasury securities are no longer issued in certificated form; they can be held only through the book-entry systems established by the Treasury and Federal Reserve Banks. The Treasury offers a book-entry system, known as "Treasury Direct" which enables individual investors to have their positions recorded directly on the books of a Federal Reserve Bank, in a fashion somewhat similar to the uncertificated direct holding system contemplated by the 1978 version of Article 8. The governing law for the Treasury Direct system, however, is set out in the applicable Treasury regulations. The Treasury Direct system is not designed for active trading.

The great bulk of Treasury securities are held not through the Treasury Direct system but through a multi-tiered indirect holding system. The Federal Reserve Banks, acting as fiscal agent for the Treasury, maintain records of the holdings of member banks of the Federal Reserve System, and those banks in turn maintain records showing the extent to which they are holding for themselves or their own customers, including government securities dealers, institutional investors, or smaller banks who in turn may act as custodians for investors. The indirect holding system for Treasury securities was established under federal regulations promulgated in the 1970s. In the 1980s, Treasury released the proposed TRADES regulations that would have established a more comprehensive body of federal commercial law for the Treasury holding system. During the Article 8 revision process, Treasury withdrew these regulations, anticipating that once Revised Article 8 is enacted, it will be possible to base the law for the Treasury system on the new Article 8 rules.

3. Broker-customer relationships.

Whether the relationship between a broker and its customer is governed by the Article 8 Part 5 rules depends on the nature of the services that the broker performs for the customer.

Some investors use brokers only to purchase and sell securities. These customers take delivery of certificates representing the securities they purchase and hold them in their own names. When they wish to sell, they deliver the

certificates to the brokers. The Article 8 Part 5 rules would not affect such customers, because the Part 5 rules deal with arrangements in which investors hold securities through securities intermediaries. The transaction between the customer and broker might be the traditional agency arrangement in which the broker buys or sells on behalf of the customer as agent for an undisclosed principal, or it might be a dealer transaction in which the "broker" as principal buys from or sells to the customer. In either case, if the customer takes delivery and holds the securities directly, she will become the "purchaser" of a "security" whose interest therein is governed by the rules of Parts 2, 3, and 4 of Article 8. If the customer meets the other requirements of Section [8-303\(a\)](#), the customer who takes delivery can qualify as a "protected purchaser" who takes free from any adverse claims under Section [8-303\(b\)](#). The broker's role in such transactions is primarily governed by non-Article 8 law. There are only a few provisions of Article 8 that affect the relationship between the customer and broker in such cases. See Sections [8-108](#) (broker makes to the customer the warranties of a transferor) and [8-115](#) (broker not liable in conversion if customer was acting wrongfully against a third party in selling securities).

Many investors use brokers not only to purchase and sell securities, but also as the custodians through whom they hold their securities. The indirect holding system rules of Part 5 apply to the custodial aspect of this relationship. If a customer purchases a security through a broker and directs the broker to hold the security in an account for the customer, the customer will never become a "purchaser" of a "security" whose interest therein is governed by the rules of Parts 2, 3, and 4 of Article 8. Accordingly, the customer does not become a "protected purchaser" under Section [8-303](#). Rather, the customer becomes an "entitlement holder" who has a "security entitlement" to the security against the broker as "securities intermediary." See Section [8-501](#). It would make no sense to say that the customer in such a case takes an interest in the security free from all other claims, since the nature of the relationship is that the customer has an interest in common with other customers who hold positions in the same security through the same broker. Section [8-502](#), however, does protect an entitlement holder against adverse claims, in the sense that once the entitlement holder has acquired the package of rights that comprise a security entitlement no one else can take that package of rights away by arguing that the transaction that resulted in the customer's acquisition of the security entitlement was the traceable product of a transfer or transaction that was wrongful as against the claimant.

4. Bank deposit accounts; brokerage asset management accounts.

An ordinary bank deposit account would not fall within the definition of "security" in Section [8-102\(a\)\(15\)](#), so the rules of Parts 2, 3, and 4 of Article 8 do not apply to deposit accounts. Nor would the relationship between a bank and its depositors be governed by the rules of Part 5 of Article 8. The Part 5 rules apply to "security entitlements." Section [8-501\(b\)](#) provides that a person has a security entitlement when a securities intermediary credits a financial asset to the person's "securities account." "Securities account" is defined in Section [8-501\(a\)](#) as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." The definition of securities

account plays a key role in setting the scope of Part 5 of Article 8. A person has a security entitlement governed by Part 5 only if the relationship in question falls within the definition of "securities account." The definition of securities account in Section [8-501\(a\)](#) excludes deposit accounts from the Part 5 rules of Article 8. One of the basic elements of the relationship between a securities intermediary and an entitlement holder is that the securities intermediary has the duty to hold exactly the quantity of securities that it carries for the account of its customers. See Section [8-504](#). The assets that a securities intermediary holds for its entitlement holder are not assets that the securities intermediary can use in its own proprietary business. See Section [8-503](#). A deposit account is an entirely different arrangement. A bank is not required to hold in its vaults or in deposit accounts with other banks a sum of money equal to the claims of all of its depositors. Banks are permitted to use depositors' funds in their ordinary lending business; indeed, that is a primary function of banks. A deposit account, unlike a securities account, is simply a debtor-creditor relationship. Thus a bank or other financial institution maintaining deposit accounts is not covered by Part 5 of Article 8.

Today, it is common for brokers to maintain securities accounts for their customers which include arrangements for the customers to hold liquid "cash" assets in the form of money market mutual fund shares. Insofar as the broker is holding money market mutual fund shares for its customer, the customer has a security entitlement to the money market mutual fund shares. It is also common for brokers to offer their customers an arrangement in which the customer has access to those liquid assets via a deposit account with a bank, whereby shares of the money market fund are redeemed to cover checks drawn on the account. Article 8 applies only to the securities account; the linked bank account remains an account covered by other law. Thus the rights and duties of the customer and the bank are governed not by Article 8, but by the relevant payment system law, such as Article 4 or Article 4A.

5. Trusts.

The indirect holding system rules of Part 5 of Article 8 are not intended to govern all relationships in which one person holds securities "on behalf of" another. Rather, the Part 5 rules come into play only if the relationship in question falls within the definition of securities account in Section [8-501\(a\)](#). The definition of securities account serves the important function of ensuring that ordinary trust arrangements are not inadvertently swept into Part 5 of Article 8. Suppose that Bank serves as trustee of a trust for the benefit of Beneficiary. The corpus of the trust is invested in securities and other financial assets. Although Bank is, in some senses, holding securities for Beneficiary, the arrangement would not fall within the definition of securities account. Bank, as trustee, has not undertaken to treat Beneficiary as entitled to exercise all of the rights that comprise the portfolio securities. For instance, although Beneficiary receives the economic benefit of the portfolio securities, Beneficiary does not have the right to direct dispositions of individual trust assets or to exercise voting or other corporate law rights with respect to the individual securities. Thus Bank's obligations to Beneficiary as trustee are governed by ordinary trust law, not by Part 5 of Article 8. Of course, if Bank, as trustee, holds the securities through an intermediary, Part 5 of Revised Article 8 would govern the relationship between Bank, as entitlement holder, and the intermediary through which Bank holds the

securities. It is also possible that a different department of Bank acts as the intermediary through which Bank, as trustee, holds the securities. Bank, *qua* securities custodian, might be holding securities for a large number of customers, including Bank's own trust department. Insofar as Bank may be regarded as acting in different capacities, Part 5 of Article 8 may be relevant to the relationship between the two sides of Bank's business. However, the relationship between Bank as trustee and the beneficiaries of the trust would remain governed by trust law, not Article 8.

6. Mutual fund shares.

Shares of mutual funds are Article 8 securities, whether the fund is organized as a corporation, business trust, or other form of entity. See Sections [8-102\(a\)\(15\)](#) and [8-103\(b\)](#). Mutual funds commonly do not issue certificates. Thus, mutual fund shares are typically uncertificated securities under Article 8.

Although a mutual fund is, in a colloquial sense, holding the portfolio securities on behalf of the fund's shareholders, the indirect holding system rules of Part 5 do not apply to the relationship between the fund and its shareholders. The Part 5 rules apply to "security entitlements." Section [8-501\(e\)](#) provides that issuance of a security is not establishment of a security entitlement. Thus, because mutual funds shares do fit within the Article 8 definition of security, the relationship between the fund and its shareholders is automatically excluded from the Part 5 rules.

Of course, a person might hold shares in a mutual fund through a brokerage account. Because mutual fund shares are securities, they automatically fall within the broader term "financial asset," so the Part 5 indirect holding system rules apply to mutual fund shares that are held through securities accounts. That is, a person who holds mutual fund shares through a brokerage account could have a security entitlement to the mutual fund shares, just as the person would have a security entitlement to any other security carried in the brokerage account.

7. Stock of closely held corporations.

Ordinary corporate stock falls within the Article 8 definition of security, whether or not it is publicly traded. See Sections [8-102\(a\)\(15\)](#) and [8-103\(a\)](#). There is nothing in the new indirect holding system rules of Article 8 that would preclude their application to shares of companies that are not publicly traded. The indirect holding system rules, however, would come into play only if the shares were in fact held through a securities account with a securities intermediary. Since that is typically not the case with respect to shares of closely held corporations, transactions involving those shares will continue to be governed by the traditional rules, as amended, that are set out in Parts 2, 3, and 4 of Article 8, and the corresponding provisions of Article 9. The simplification of the Article 8 rules on uncertificated securities may, however, make the alternative of dispensing with certificates more attractive for closely held corporations.

8. Partnership interests and limited liability company shares.

Interests in partnerships or shares of limited liability companies are not Article 8 securities unless they are in fact dealt in or traded on securities exchanges or in securities markets. See Section [8-103\(c\)](#). The issuers, however, may if they wish explicitly "opt-in" by specifying that the interests or shares are securities governed by Article 8. Even though interests in partnerships or shares of limited liability companies do not generally fall within the category of "security" in Article 8, they would fall within the broader term "financial asset." Accordingly, if such interests are held through a securities account with a securities intermediary, the indirect holding system rules of Part 5 apply, and the interest of a person who holds them through such an account is a security entitlement.

9. Bankers' acceptances, commercial paper, and other money market instruments.

Money market instruments, such as commercial paper, bankers' acceptances, and certificates of deposit, are good examples of a form of property that may fall within the definition of "financial asset," even though they may not fall within the definition of "security." Section [8-103\(d\)](#) provides that a writing that meets the definition of security certificate under Section [8-102\(a\)\(15\)](#) is governed by Article 8, even though it also fits within the definition of "negotiable instrument" in Article 3.

Some forms of short term money market instruments may meet the requirements of an Article 8 security, while others may not. For example, the Article 8 definition of security requires that the obligation be in registered or bearer form. Bankers' acceptances are typically payable "to order," and thus do not qualify as Article 8 securities. Thus, the obligations of the immediate parties to a bankers' acceptance are governed by Article 3, rather than Article 8. That is an entirely appropriate classification, even for those bankers' acceptance that are handled as investment media in the securities markets, because Article 8, unlike Article 3, does not contain rules specifying the standardized obligations of parties to instruments. For example, the Article 3 rules on the obligations of acceptors and drawers of drafts are necessary to specify the obligations represented by bankers' acceptances, but Article 8 contains no provisions dealing with these issues.

Immobilization through a depository system is, however, just as important for money market instruments as for traditional securities. Under the prior version of Article 8, the rules on the depository system, set out in Section 8-320, applied only to Article 8 securities. Although some forms of money market instruments could be fitted within the language of the Article 8 definition of "security," this is not true for bankers' acceptances. Accordingly, it was not thought feasible to make bankers' acceptances eligible for deposit in clearing corporations under the prior version of Article 8. Revised Article 8 solves this problem by separating the coverage of the Part 5 rules from the definition of security. Even though a bankers' acceptance or other money market instrument is an Article 3 negotiable instrument rather than an Article 8 security, it would still fall within the definition of financial asset in Section [8-102\(a\)\(9\)](#). Accordingly, if the instrument is held through a clearing corporation or other securities intermediary, the rules of Part 5 of Article 8 apply.

10. Repurchase agreement transactions.

Repurchase agreements are an important form of transaction in the securities business, particularly in connection with government securities. Repos and reverse repos can be used for a variety of purposes. The one that is of particular concern for purposes of commercial law rules is the use of repurchase agreements as a form of financing transaction for government securities dealers. Government securities dealers typically obtain intra-day financing from their clearing banks, and then at the end of the trading day seek overnight financing from other sources to repay that day's advances from the clearing bank. Repos are the principal source of this financing. The dealer ("repo seller") sells securities to the financing source ("repo buyer") for cash, and at the same time agrees to repurchase the same or like securities the following day, or at some other brief interval. The sources of the financing include a variety of entities seeking short term investments for surplus cash, such as pension funds, business corporations, money market funds, and banks. The pricing may be computed in various ways, but in essence the price at which the dealer agrees to repurchase the securities exceeds the price paid to the dealer by an amount equivalent to interest on the funds.

The transfer of the securities from a securities dealer as repo seller to a provider of funds as repo buyer can be effected in a variety of ways. The repo buyer might be willing to allow the repo seller to keep the securities "in its hands," relying on the dealer's representation that it will hold them on behalf of the repo buyer. In the jargon of the trade, these are known as "hold-in-custody repos" or "HIC repos." At the other extreme, the repo buyer might insist that the dealer "hand over" the securities so that in the event that the dealer fails and is unable to perform its obligation to repurchase them, the repo buyer will have the securities "in its hands." The jargon for these is "delivered-out repos." A wide variety of arrangements between these two extremes might be devised, in which the securities are "handed over" to a third party with powers concerning their disposition allocated between the repo seller and repo buyer in a variety of ways.

Specification of the rights of repo buyers is complicated by the fact that the transfer of the interest in securities from the repo seller to the repo buyer might be characterized as an outright sale or as the creation of a security interest. Article 8 does not attempt to specify any categorical rules on that issue.

Article 8 sets out rules on the rights of parties who have implemented securities transactions in certain ways. It does not, however, deal with the legal characterization of the transactions that are implemented through the Article 8 mechanisms. Rather, the Article 8 rules apply without regard to the characterization of transactions for other purposes. For example, the Article 8 rules for the direct holding system provide that a person who takes delivery of a duly indorsed security certificate for value and without notice of adverse claims takes free from any adverse claims. That rule applies without regard to the character of the transaction in which the security certificate was delivered. It applies both to delivery upon original issue and to delivery upon transfer. It applies to transfers in settlement of sales and to transfers in pledge. Similarly, the Article 8 indirect holding system rules, such as the adverse claim cut-off rules in Sections [8-502](#) and [8-510](#), apply to the transactions that fall within their terms, whether those transactions were sales, secured transactions, or something else.

Repos involve transfers of interests in securities. The Article 8 rules apply to transfers of securities in repos, just as they apply to transfers of securities in any other form of transaction. The transfer of the interest in securities from the repo seller to the repo buyer might be characterized as an outright sale or as the creation of a security interest. Article 8 does not determine that question. The rules of Revised Article 8 have, however, been drafted to minimize the possibility that disputes over the characterization of the transfer in a repo would affect substantive questions that are governed by Article 8. See, e.g., Section [8-510](#) and Comment 4 thereto.

11. Securities lending transactions.

In a typical securities lending transaction, the owner of securities lends them to another person who needs the securities to satisfy a delivery obligation. For example, when a customer of a broker sells a security short, the broker executes an ordinary trade as seller and so must deliver the securities at settlement. The customer is "short" against the broker because the customer has an open obligation to deliver the securities to the broker, which the customer hopes to be able to satisfy by buying in the securities at a lower price. If the short seller's broker does not have the securities in its own inventory, the broker will borrow them from someone else. The securities lender delivers the securities to the borrowing broker, and the borrowing broker becomes contractually obligated to redeliver a like quantity of the same security. Securities borrowers are required to provide collateral, usually government securities, to assure performance of their redelivery obligation.

The securities lender does not retain any property interest in the securities that are delivered to the borrower. The transaction is an outright transfer in which the borrower obtains full title. The whole point of securities lending is that the borrower needs the securities to transfer them to someone else. It would make no sense to say that the lender retains any property interest in the securities it has lent. Accordingly, even if the securities borrower defaults on its redelivery obligation, the securities lender has no property interest in the original securities that could be asserted against any person to whom the securities borrower may have transferred them. One need not look to adverse claim cut-off rules to reach that result; the securities lender never had an adverse claim. The securities borrower's default is no different from any other breach of contract. The securities lender's protection is its right to foreclose on the collateral given to secure the borrower's redelivery obligation. Perhaps the best way to understand securities lending is to note that the word "loan" in securities lending transactions is used in the sense it carries in loans of money, as distinguished from loans of specific identifiable chattels. Someone who lends money does not retain any property interest in the money that is handed over to the borrower. To use civil law terminology, securities lending is *mutuum*, rather than *commodatum*. See Story on Bailments, §§ 6 and 47.

12. Traded stock options.

Stock options issued and cleared through the Options Clearing Corporation ("OCC") are a good example of a form of investment vehicle that is treated as a financial asset to which the Part 5 rules apply, but not as an Article 8 security to which Parts 2, 3, and 4 apply. OCC carries on its books the options positions of

the brokerage firms which are clearing members of OCC. The clearing members in turn carry on their books the options positions of their customers. The arrangements are structurally similar to the securities depository system. In the options structure, however, there is no issuer separate from the clearing corporation. The financial assets held through the system are standardized contracts entitling the holder to purchase or sell a certain security at a set price. Rather than being an interest in or obligation of a separate issuer, an option is a contractual right against the counter-party. In order to assure performance of the options, OCC interposes itself as counter-party to each options trade. The rules of Parts 2, 3, and 4 of this Article, however, do not well describe the obligations and rights of OCC. On the other hand, the rules of Part 5, and the related Article 9 rules on security interests and priorities, do provide a workable legal framework for the commercial law analysis of the rights of the participants in the options market. Accordingly, publicly traded securities options are included within the definition of "financial asset," but not "security." See Section [8-103\(e\)](#). Thus, although OCC would not be an issuer of a security for purposes of this Article, it would be a clearing corporation, against whom its clearing members have security entitlements to the options positions. Similarly, the clearing members' customers have security entitlements against the clearing members. Traded stock options are also a good illustration of the point that the classification issues under Article 8 are very different from classification under other law, such as the federal securities laws. See Section [8-102\(d\)](#). Stock options are treated as securities for purposes of federal securities laws, but not for purposes of Article 8.

13. Commodity futures.

Section [8-103\(f\)](#) provides that a "commodity contract" is not a security or a financial asset. Section [9-102\(a\)\(15\)](#) defines commodity contract to include commodity futures contracts, commodity options, and options on commodity futures contracts that are traded on or subject to the rules of a board of trade that has been designated as a contract market for that contract pursuant to the federal commodities laws. Thus, commodity contracts themselves are not Article 8 securities to which the rules of Parts 2, 3, and 4 apply, nor is the relationship between a customer and a commodity futures commission merchant governed by the Part 5 rules of Article 8. Commodity contracts, however, are included within the Article 9 definition of "investment property." Thus security interests in commodity positions are governed by essentially the same set of rules as security interests in security entitlements.

14. "Whatever else they have or may devise."

The classification question posed by the above-captioned category of investment products and arrangements is among the most difficult -- and important -- issue raised by the Article 8 revision process. Rapid innovation is perhaps the only constant characteristic of the securities and financial markets. The rules of Revised Article 8 are intended to be sufficiently flexible to accommodate new developments.

A common mechanism by which new financial instruments are devised is that a financial institution that holds some security, financial instrument, or pool thereof, creates interests in that asset or pool which are sold to others. It is not

possible to answer in the abstract the question of how such interests are treated under Article 8, because the variety of such products is limited only by human imagination and current regulatory structures. At this general level, however, one can note that there are at least three possible treatments under Article 8 of the relationship between the institution which creates the interests and the persons who hold them. (Again, it must be borne in mind that the Article 8 classification issue may be different from the classification question posed by federal securities law or other regulation.) First, creation of the new interests in the underlying assets may constitute issuance of a new Article 8 security. In that case the relationship between the institution that created the interest and the persons who hold them is not governed by the Part 5 rules, but by the rules of Parts 2, 3, and 4. See Section [8-501\(e\)](#). That, for example, is the structure of issuance of mutual fund shares. Second, the relationship between the entity creating the interests and those holding them may fit within the Part 5 rules, so that the persons are treating as having security entitlements against the institution with respect to the underlying assets. That, for example, is the structure used for stock options. Third, it may be that the creation of the new interests in the underlying assets does not constitute issuance of a new Article 8 security, nor does the relationship between the entity creating the interests and those holding them fit within the Part 5 rules. In that case, the relationship is governed by other law, as in the case of ordinary trusts.

The first of these three possibilities -- that the creation of the new interest is issuance of a new security for Article 8 purposes -- is a fairly common pattern. For example, an American depository receipt facility does not maintain securities accounts but issues securities called ADRs in respect of foreign securities deposited in such facility. Similarly, custodians of government securities which issue receipts, certificates, or the like representing direct interests in those securities (sometimes interests split between principal and income) do not maintain securities accounts but issue securities representing those interests. Trusts holding assets, in a variety of structured and securitized transactions, which issue certificates or the like representing "pass-through" or undivided beneficial interests in the trust assets, do not maintain securities accounts but issue securities representing those interests.

In analyzing these classification questions, courts should take care to avoid mechanical jurisprudence based solely upon exegesis of the wording of definitions in Article 8. The result of classification questions is that different sets of rules come into play. In order to decide the classification question it is necessary to understand fully the commercial setting and consider which set of rules best fits the transaction. Rather than letting the choice of rules turn on interpretation of the words of the definitions, the interpretation of the words of the definitions should turn on the suitability of the application of the substantive rules.

IV. CHANGES FROM PRIOR (1978) VERSION OF ARTICLE 8

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- 8-102(1)(b) [8-102\(a\)](#)(15) & (18)
- 8-102(1)(c) [8-102\(a\)](#)(15)
- 8-102(1)(d) [8-102\(a\)](#)(13)
- 8-102(1)(e) [8-102\(a\)](#)(2)
- 8-102(2) [8-202\(b\)](#)(1)
- 8-102(3) [8-102\(a\)](#)(5)
- 8-102(4) omitted, see [Revision Note 1](#)
- 8-102(5) [8-102\(b\)](#)
- 8-102(6) [8-102\(c\)](#)
- 8-103 [8-209](#)
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- 8-105(1) omitted, see [Revision Note 8](#)
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omitted, see [Revision Note 4](#)
- 8-202 [8-203](#)
[8-204](#);
transaction
statement
provisions
omitted, see [Revision Note 4](#)
- 8-203 [8-203](#)
[8-204](#);
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- 8-204 [8-205](#);
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omitted, see [Revision Note 4](#)
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statement
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- 8-206 [8-206](#);
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- 8-304(1) [8-105\(d\)](#)
- 8-304(2) omitted, see
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- 8-304(3) [8-105\(b\)](#)
- 8-305 [8-105\(c\)](#)
- 8-306(1) [8-108\(f\)](#)
- 8-306(2) [8-108\(a\)](#)
- 8-306(3) [8-108\(g\)](#)
- 8-306(4) [8-108\(h\)](#)
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- 8-306(6) [8-306\(h\)](#)
- 8-306(7) [8-108\(b\)](#), [8-306\(h\)](#)
- 8-306(8) omitted, see
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- 8-306(9) [8-108\(c\)](#)
- 8-306(10) [8-108\(i\)](#)
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- 8-308(1) [8-102\(a\)](#)(11),
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- 8-308(2) [8-304\(a\)](#)
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- 8-308(4) [8-102\(a\)](#)(12)
- 8-308(5) [8-107](#) & [8-305\(a\)](#)
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- 8-309 [8-304\(c\)](#)
- 8-310 [8-304\(e\)](#)
- omitted, see [8-106\(b\)](#)(2), [8-301\(b\)](#)(1), [8-303](#)
- 8-311(a)
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- 8-312 [8-306](#)
- omitted, see [Revision Note 2](#); see also [8-301\(a\)](#)(1) & (2)
- 8-313(1)(a)
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- omitted, see [Revision Note 2](#); see also [8-301\(a\)](#)(2)
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- omitted, [Revision Note 2](#); see also [8-301\(b\)](#)(2)
- 8-313(1)(f)
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- 313(1)(h)-(j) [Revision Note 2](#); see also [9-203](#)
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- 8-313(2) [Revision Note 2](#); see also [8-503](#)
- 8-313(3) omitted, see [Revision Note 2](#)
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- 8-314 omitted, see [Revision Note 8](#)
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- 8-317 [8-112](#)
- 8-318 [8-115](#)
- 8-319 omitted, see [8-113](#) and [Revision Note 7](#)
- 8-320 omitted, see [Revision Note 1](#)
- 8-321 omitted, see [9-203](#), [9-309](#), [9-312](#), [9-314](#)
- 8-401 [8-401](#)
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- 8-404 [8-404](#)
- 8-405(1) [8-406](#)
- 8-405(2) [8-405\(a\)](#)
- 8-405(3) [8-405\(b\)](#)
- 8-406 [8-407](#)
- 8-407 omitted, see [Revision Note 8](#)
- 8-408 omitted, see [Revision Note 4](#)

B. Revision Notes

1. Provisions of former Article 8 on clearing corporations.

The keystone of the treatment of the indirect holding system in the prior version of Article 8 was the special provision on clearing corporations in Section 8-320. Section 8-320 was added to Article 8 in 1962, at the very end of the process that

culminated in promulgation and enactment of the original version of the Code. The key concepts of the original version of Article 8 were "bona fide purchaser" and "delivery." Under Section 8-302 (1962) one could qualify as a "bona fide purchaser" only if one had taken delivery of a security, and Section 8-313 (1962) specified what counted as a delivery.

Section 8-320 was added to take account of the development of the system in which trades can be settled by netted book-entry movements at a depository without physical deliveries of certificates. Rather than reworking the basic concepts, however, Section 8-320 brought the depository system within Article 8 by definitional fiat. Subsection (a) of Section 8-320 (1962) stated that a transfer or pledge could be effected by entries on the books of a central depository, and subsection (b) stated that such an entry "has the effect of a delivery of a security in bearer form or duly indorsed in blank." In 1978, Section 8-320 was revised to conform it to the general substitution of the concept of "transfer" for "delivery," but the basic structure remained the same. Under the 1978 version of Article 8, the only book-entry transfers that qualified the transferee for bona fide purchaser rights were those made on the books of a clearing corporation. See Sections 8-302(1)(c), 8-313(1)(g), and 8-320. Thus, for practical purposes, the indirect holding system rules of the prior version of Article 8 required that the securities be held by a clearing corporation in accordance with the central depository rules of Section 8-320.

Some of the definitional provisions concerning clearing corporation in the prior version of Article 8 seem to have conflated the commercial law rules on the effect of book-entry transactions with issues about the regulation of entities that are acting as clearing corporations. For example, the Section 8-320 rules that gave effect to book-entry transfers applied only if the security was "in the custody of the clearing corporation, another clearing corporation, [or] a custodian bank." "Custodian bank" was defined in Section 8-102(4) as "a bank or trust company that is supervised and examined by state or federal authority having supervision over banks and is acting as custodian for a clearing corporation." Although this was probably inadvertent, these definitional provisions have operated as an obstacle to the development of clearing arrangements for global trading, since they effectively precluded clearing corporations from using foreign banks as custodians.

Revised Article 8 is based on the view that Article 8 is not the proper place for regulatory decisions about whether certain sorts of financial institutions should or should not be permitted to engage in a particular aspect of the securities business, such as acting as a clearing corporation, or how they should be permitted to conduct that business. Rather, Article 8 should deal only with the commercial law questions of what duties and rights flow from doing business as a clearing corporation, leaving it to other regulatory law to decide which entities should be permitted to act as clearing corporations, and to regulate their activities. Federal securities laws now establish a detailed regulatory structure for clearing corporations; there is no need for Article 8 to duplicate parts of that structure. Revised Article 8 deletes all provision of the prior version which had the effect of specifying how clearing corporations should conduct their operations. For example, Revised Article 8 deletes the definition of "custodian bank," which operated in the prior version only as a regulatory restriction on how clearing corporations could hold securities.

In general, the structure of Revised Article 8 is such that there is relatively little need for special provisions on clearing corporations. Book-entry transactions effected through clearing corporations are treated under the same rules in Part 5 as book-entry transactions effected through any other securities intermediary. Accordingly, Revised Article 8 has no direct analog of the special provisions in Section 8-320 on transfers on the books of clearing corporations.

2. Former Section 8-313 -- "Transfer."

Section 8-313 of the 1978 version of Article was extremely complicated, because it attempted to cover many different issues. The following account of the evolution of Section 8-313 may assist in understanding why a different approach is taken in Revised Article 8. This explanation is, however, intended not as an actual account of historical events, but as a conceptual reconstruction, devised from the perspective of, and with the benefit of, hindsight.

The original objective of Article 8 was to ensure that certificates representing investment securities would be "negotiable" in the sense that purchasers would be protected by the bona fide purchaser rules. The requirements for bona fide purchaser status were that the purchaser had to (i) take delivery of the security and (ii) give value in good faith and without notice of adverse claims. Section 8-313 specified what counted as a "delivery," and Section 8-302 specified the other requirements.

The 1978 amendments added provisions on uncertificated securities, but the basic organizational pattern was retained. Section 8-302 continued to state the requirements of value, good faith, and lack of notice for good faith purchase, and Section 8-313 stated the mechanism by which the purchase had to be implemented. Delivery as defined in the original version of Section 8-313 had a meaning similar to the concept known in colloquial securities jargon as "good delivery"; that is, physical delivery with any necessary indorsement. Although the word "delivery" has now come to be used in securities parlance in a broader sense than physical delivery, when the provisions for uncertificated securities were added it was thought preferable to use another word. Thus, the word "transfer" was substituted for "delivery" in Section 8-313.

The 1978 amendments also moved the rules governing security interests in securities from Article 9 to Article 8, though the basic conceptual structure of the common law of pledge was retained. Since a pledge required a delivery, and since the term transfer had been substituted for delivery, the 1978 amendments provided that in order to create a security interest there must be a "transfer," in the defined Article 8 sense, from the debtor to the secured party. Accordingly, provisions had to be added to Section 8-313 so that any of the steps that should suffice to create a perfected security interest would be deemed to constitute a "transfer" within the meaning of Section 8-313. Thus, the Section 8-313 rules on "transfer," which had in the previous version dealt only with what counted as a delivery that qualified one for bona fide purchaser status, became the statutory locus for all of the rules on creation and perfection of security interests in securities. Accordingly the rather elaborate rules of subsections (1)(h), (1)(i), and (1)(j) were added.

Having expanded Section 8-313 to the point that it served as the rule specifying the formal requirements for transfer of all significant forms of interests in securities, it must have seemed only logical to take the next step and make the Section 8-313 rules the exclusive means of transferring interests in securities. Thus, while the prior version had stated that "Delivery to a purchaser occurs when ...", the 1978 version stated that "Transfer of a security or a limited interest (including a security interest) therein to a purchaser occurs *only*" Having taken that step, however, it then became necessary to ensure that anyone who should be regarded as having an interest in a security would be covered by some provision of Section 8-313. Thus, the provisions of subsection (1)(d)(ii) and (iii) were added to make it possible to say that the customers of a securities intermediary who hold interests in securities held by the intermediary in fungible bulk received "transfers."

Section 8-313(1)(d) was the key provision in the 1978 version dealing with the indirect holding system at the level below securities depositories. It operated in essentially the same fashion as Section 8-320; that is, it stated that when a broker or bank holding securities in fungible bulk makes entries on its books identifying a quantity of the fungible bulk as belonging to the customer, that action is treated as a "transfer" -- in the special Section 8-313 sense -- of an interest in the security from the intermediary to the customer.

Revised Article 8 has no direct analog of the 1978 version of Section 8-313. The rules on secured transactions have been returned to Article 9, so subsections of Section 8-313 (1978) dealing with security interests are deleted from Article 8. Insofar as portions of Section 8-313 (1978) were designed to specify the formal requirements for transferees to qualify for protection against adverse claims, their place is taken by Revised Section 8-301, which defines "delivery," in a fashion somewhat akin to the pre-1978 version of Section 8-313. The descendant of the provisions of Section 8-313 (1978) dealing with the indirect holding system is Revised Section 8-501 which specifies when a person acquires a security entitlement. Section 8-501, however, is based on a different analysis of the transaction in which a customer acquires a position in the indirect holding system. The transaction is not described as a "transfer" of an interest in some portion of a fungible bulk of securities held by the securities intermediary but as the creation of a security entitlement. Accordingly, just as Revised Article 8 has no direct analog of the Section 8-320 rules on clearing corporation transfers, it has no direct analog of the Section 8-313(1) rules on "transfers" of interests in securities held in fungible bulk.

3. Uncertificated securities provisions.

Given the way that securities holding practices have evolved, the sharp distinction that the 1978 version of Article 8 drew between certificated securities and uncertificated securities has become somewhat misleading. Since many provisions of the 1978 version had separate subsections dealing first with certificated securities and then with uncertificated securities, and since people intuitively realize that the volume of trading in the modern securities markets could not possibly be handled by pushing around certificates, it was only natural for a reader of the statute to conclude that the uncertificated securities provisions of Article 8 were the basis of the book-entry system. That, however, is not the case. Although physical delivery of certificates plays little role in the settlement

system, most publicly traded securities are still, in legal theory, certificated securities. To use clearance and settlement jargon, the book-entry securities holding system has used "immobilization" rather than "dematerialization."

The important legal and practical difference is between the direct holding system, in which the beneficial owners have a direct relationship with the issuer, and the indirect holding system, in which securities are held through tiers of securities intermediaries. Accordingly, in Revised Article 8 the contrast between certificated securities and uncertificated securities has been minimized or eliminated as much as possible in stating the substantive provisions.

4. Transaction statements.

Although the 1978 provisions on uncertificated securities contemplated a system in which there would be no definitive certificates as reifications of the underlying interests or obligations, the 1978 amendments did not really dispense with all requirements of paper evidence of securities holding. The 1978 amendments required issuers of uncertificated securities to send paper "transaction statements" upon registration of transfer. Section 8-408 regulated the content and format of these transaction statements in considerable detail. The statements had to be in writing, include specific information, and contain a conspicuous legend stating that "This statement is merely a record of the rights of the addressee as of the time of its issuance. Delivery of this statement, of itself, confers no rights on the recipient. This statement is neither a negotiable instrument nor a security." Issuers were required to send statements when any transfer was registered (known as "initial transaction statements") and also were required to send periodic statements at least annually and also upon any security holder's reasonable request. Fees were regulated to some extent, in that Section 8-408(8) specified that if periodic statements were sent at least quarterly, the issuer could charge for statements requested by security holders at other times.

The detailed specification of reporting requirements for issuers of uncertificated securities was quite different from the treatment of securities intermediaries. Though the prior version of Article 8 did require non-clearing corporation securities intermediaries to send confirmations of transfers -- a requirement deleted in Revised Article 8 -- it did not regulate their content or format. Article 8 has never imposed periodic reporting requirements on securities intermediaries. Thus, reporting requirements for the indirect holding system were left to agreements and regulatory authorities, while reporting requirements for a book-entry direct holding system were imposed by statute.

Securities holding systems based on transaction statements of the sort contemplated by the 1978 amendments have not yet evolved to any major extent -- indeed, the statutory specification of the details of the information system may itself have acted as an impediment to the evolution of a book-entry direct system. Accordingly, Revised Article 8 drops the statutory requirements concerning transaction statements. The record keeping and reporting obligations of issuers of uncertificated securities would be left to agreement and other law, as is the case today for securities intermediaries.

In the 1978 version, the Part 2 rules concerning transfer restrictions, issuers' defenses, and the like were based on the assumption that transaction statements

would be used in a fashion analogous to traditional security certificates. For example, Sections 8-202 and 8-204 specified that the terms of a security, or any restrictions on transfer imposed by the issuer, had to be noted on the transaction statement. Revised Article 8 deletes all such references to transaction statements. The terms of securities, or of restrictions of transfer, would be governed by whatever law or agreement specifies these matters, just as is the case for various other forms of business entities, such as partnerships, that have never issued certificates representing interests. Other Part 2 rules, such as Sections 8-205, 8-206, and 8-208, attempted to state rules on forgery and related matters for transactions statements. Since Revised Article 8 does not specify the format for information systems for uncertificated securities, there is no point in attempting to state rules on the consequences of wrongful information transmission in the particular format of written statements authenticated by signatures.

5. Deletion of provisions on registered pledges.

The 1978 version of Article 8 also added detailed provisions concerning "registered pledges" of uncertificated securities. Revised Article 8 adopts a new system of rules for security interests in securities, for both the direct and indirect holding systems that make it unnecessary to have special statutory provisions for registered pledges of uncertificated securities.

The reason that the 1978 version of Article 8 created this concept was that if the only means of creating security interests was the pledge, it seemed necessary to provide some substitute for the pledge in the absence of a certificate. The point of the registered pledge was, presumably, that it permitted a debtor to grant a perfected security interest in securities, yet still keep the securities in the debtor's own name for purposes of dividends, voting, and the like. The concept of registered pledge has, however, been thought troublesome by many legal commentators and securities industry participants. For example, in Massachusetts where many mutual funds have their headquarters, a non-uniform amendment was enacted to permit the issuer of an uncertificated security to refuse to register a pledge and instead issue a certificate to the owner that the owner could then pledge by ordinary means.

Under the 1978 version of Article 8, if an issuer chose to issue securities in uncertificated form, it was also required by statute to offer a registered pledge program. Revised Articles 8 and 9 take a different approach. All of the provisions dealing with registered pledges have been deleted. This does not mean, however, that issuers cannot offer such a service. The control rules of Revised Section 8-106 and the related priority provisions in Article 9 establish a structure that permits issuers to develop systems akin to the registered pledge device, without mandating that they do so, or legislating the details of the system. In essence, the registered pledge or control device amounts to a record keeping service. A debtor can always transfer securities to its lender. In a registered pledge or control agreement arrangement, the issuer keeps track of which securities the secured party holds for its own account outright, and which securities it holds in pledge from its debtors.

Under the rules of Revised Articles 8 and 9, the registered pledge issue can easily be left to resolution by the market. The concept of control is defined in such

fashion that if an issuer or securities intermediary wishes to offer a service akin to the registered pledge device it can do so. The issuer or securities intermediary would offer to enter into agreements with the debtor and secured party under which it would hold the securities for the account of the debtor, but subject to instructions from the secured party. The secured party would thereby obtain control assuring perfection and priority of its lien.

Even if such arrangements are not offered by issuers, persons who hold uncertificated securities will have several options for using them as collateral for secured loans. Under the new rules, filing is a permissible method of perfection, for debtors other than securities firms. A secured party who relies on filing is, of course, exposed to the risk that the debtor will double finance and grant a later secured lender a security interest under circumstances that give that lender control and hence priority. If the lender is unwilling to run that risk, the debtor can transfer the securities outright to the lender on the books of the issuer, though between the parties the debtor would be the owner and the lender only a secured party. That, of course, requires that the debtor trust the secured party not to dispose of the collateral wrongfully, and the debtor may also need to make arrangements with the secured party to exercise benefits of ownership such as voting and receiving distributions.

It may well be that both lenders and borrowers would prefer to have some arrangement, such as the registered pledge device of current law, that permits the debtor to remain as the registered owner entitled to vote and receive dividends but gives the lender exclusive power to order their disposition. The approach taken in this revision is that if there is a genuine demand for such arrangements, it can be met by the market. The difficulty with the approach of present Article 8 is that it mandates that any issuer that wishes to issue securities in uncertificated form must also offer this record keeping service. That obligation may well have acted as a disincentive to the development of uncertificated securities. Thus, the deletion of the mandated registered pledge provisions is consistent with the principle of neutrality toward the evolution of securities holding practices.

6. Former Section 8-403 -- Issuer's Duty as to Adverse Claims.

Section 8-403 of the prior version of Article 8 dealt with the obligations of issuers to adverse claimants. The starting point of American law on issuers' liability in such circumstances is the old case of *Lowry v. Commercial & Farmers' Bank*, 15 F. Cas. 1040 (C.C.D. Md. 1848) (No. 8551), under which issuers could be held liable for registering a transfer at the direction of a registered owner who was acting wrongfully as against a third person in making the transfer. The *Lowry* principle imposed onerous liability on issuers, particularly in the case of transfers by fiduciaries, such as executors and trustees. To protect against risk of such liability, issuers developed the practice of requiring extensive documentation for fiduciary stock transfers to assure themselves that the fiduciaries were acting rightfully. As a result, fiduciary stock transfers were cumbersome and time consuming.

In the present century, American law has gradually moved away from the *Lowry* principle. Statutes such as the Uniform Fiduciaries Act, the Model Fiduciary Stock Transfer Act, and the Uniform Act for the Simplification of Fiduciary Security

Transfers sought to avoid the delays in stock transfers that could result from issuers' demands for documentation by limiting the issuer's responsibility for transfers in breach of the registered owner's duty to others. Although these statutes provided that issuers had no duty of inquiry to determine whether a fiduciary was acting rightfully, they all provided that an issuer could be liable if the issuer acted with notice of third party claims.

The prior version of Article 8 followed the same approach as the various fiduciary transfer statutes. Issuers were not required to seek out information from which they could determine whether a fiduciary was acting properly, but they were liable if they registered a transfer with notice that the fiduciary was acting improperly. Former Section 8-308(11) said that the failure of a fiduciary to comply with a controlling instrument or failure to obtain a court approval required under local law did not render the indorsement or instruction unauthorized. However, if a fiduciary was in fact acting improperly, then the beneficiary would be treated as an adverse claimant. See Section 8-302(2) (1978) and Comment 4. Former Section 8-403 specified that if written notice of an adverse claim had been sent to the issuer, the issuer "shall inquire into the adverse claim" before registering a transfer on the indorsement or instruction of the registered owner. The issuer could "discharge any duty of inquiry by any reasonable means," including by notifying the adverse claimant that the transfer would be registered unless the adverse claimant obtained a court order or gave an indemnity bond.

Revised Article 8 rejects the *Lowry* principle altogether. It provides that an issuer is not liable for wrongful registration if it acts on an effective indorsement or instruction, even though the issuer may have notice of adverse claims, so long as the issuer has not been served with legal process and is not acting in collusion with the wrongdoer in registering the transfer. See Revised Section 8-404 and Comments thereto. The provisions of prior Section 8-403 specifying that issuers had a duty to investigate adverse claims of which they had notice are deleted.

Revised Article 8 also deletes the provisions set out in Section 8-403(3) of prior law specifying that issuers did not have a duty to inquire into the rightfulness of transfers by fiduciaries. The omission of the rules formerly in Section 8-403(3) does not, of course, mean that issuers would be liable for acting on the instruction of fiduciaries in the circumstances covered by former Section 8-403(3). Former Section 8-403(3) assumed that issuers would be liable if they registered a transfer with notice of an adverse claim. Former Section 8-403(3) was necessary only to negate any inference that knowledge that a transfer was initiated by a fiduciary might give constructive notice of adverse claims. Under Section 8-404 of Revised Article 8, mere notice of adverse claims does not impose duties on the issuer. Accordingly the provisions included in former Section 8-403(3) are unnecessary.

Although the prior version of Article 8 included provisions similar or identical to those set out in the Uniform Act for the Simplification of Fiduciary Security Transfers and similar statutes, most states retained these statutes at the time the Uniform Commercial Code was adopted. These statutes are based on a premise different from Revised Article 8. The fiduciary simplification acts are predicated on the assumption that an issuer would be liable to an adverse claimant if the issuer had notice. These statutes seek only to preclude any inference that issuers have such notice when they register transfers on the

instructions of a fiduciary. Revised Article 8 is based on the view that a third party should not be able to interfere with the relationship between an issuer and its registered shareholders unless the claimant obtains legal process. Since notice of an adverse claim does not impose duties on an issuer under Revised Article 8, the Uniform Act for the Simplification of Fiduciary Security Transfers, or similar statutes, should be repealed upon enactment of Revised Article 8.

7. Former Section 8-319 -- Statute of Frauds.

Revised Article 8 deletes the special statute of frauds provision for securities contracts that was set out in former Section 8-319. See Revised Section 8-113. Most of the litigation involving the statute of frauds rule of the prior version of Article 8 involved informal transactions, rather than transactions on the organized securities markets. Typical cases were those in which an employee or former employee of a small enterprise sued to enforce an alleged promise that he or she would receive an equity interest in the business. The usual commercial policies relating to writings in contracts for the sale of personal property are at most tangentially implicated in such cases. There was a rather large and complex body of case law dealing with the applicability of Section 8-319 to cases of this sort. It seems doubtful that the cost of litigating these issues was warranted by whatever protections the statute of frauds offered against fraudulent claims.

Subsection (c) of former Section 8-319 provided that the statute of frauds bar did not apply if a written confirmation was sent and the recipient did not seasonably send an objection. That provision, however, presumably would not have had the effect of binding a broker's customer to the terms of a trade for which confirmation had been sent though the customer had not objected within 10 days. In the first place, the relationship between a broker and customer is ordinarily that of agent and principal; thus the broker is not seeking to enforce a contract for sale of a security, but to bind its principal for action taken by the broker as agent. Former Section 8-319 did not by its terms apply to the agency relationship. Moreover, even if former Section 8-319(c) applied, it is doubtful that it, of its own force, had the effect of precluding the customer from disputing whether there was a contract or what the terms of the contract were. Former Section 8-319(c) only removed the statute of frauds as a bar to enforcement; it did not say that there was a contract or that the confirmation had the effect of excluding other evidence of its terms. Thus, deletion of former Section 8-319 does not change the law one way or the other on whether a customer who fails to object to a written confirmation is precluded from denying the trade described in the confirmation, because that issue was never governed by former Section 8-319(c).

8. Miscellaneous.

Prior Section 8-105. Revised Article 8 deletes the statement found in Section 8-105(1) of the prior version that certificated securities "are negotiable instruments." This provision was added very late in the drafting process of the original Uniform Commercial Code. Apparently the thought was that it might be useful in dealing with potential transition problems arising out of the fact that bonds were then treated as negotiable instruments under the Uniform Negotiable Instruments Law. During that era, many other statutes, such as those specifying

permissible categories of investments for regulated entities, might have used such phrases as "negotiable securities" or "negotiable instruments." Section 8-105 seems to have been included in the original version of Article 8 to avoid unfortunate interpretations of those other statutes once securities were moved from the Uniform Negotiable Instruments Law to UCC Article 8. Whether or not Section 8-105 was necessary at that time, it has surely outlived its purpose. The statement that securities "are negotiable instruments" is very confusing. As used in the Uniform Commercial Code, the term "negotiable instrument" means an instrument that is governed by Article 3; yet Article 8 securities are not governed by Article 3. Courts have occasionally cited Section 8-105(1) of prior law for the proposition that the rules that are generally thought of as characteristic of negotiability, such as the rule that bona fide purchasers take free from adverse claims, apply to certificated securities. Section 8-105(1), however, is unnecessary for that purpose, since the relevant rules are set out in specific provisions of Article 8.

Prior Sections 8-107 and 8-314. Article 8 has never been, and should not be, a comprehensive codification of the law of contracts for the purchase and sale of securities. The prior version of Article 8 did contain, however, a number of provisions dealing with miscellaneous aspects of the law of contracts as applied to contracts for the sale of securities. Section 8-107 dealt with one remedy for breach, and Section 8-314 dealt with certain aspects of performance. Revised Article 8 deletes these on the theory that inclusion of a few sections on issues of contract law is likely to cause more harm than good since inferences might be drawn from the failure to cover related issues. The deletion of these sections is not, however, intended as a rejection of the rules of contract law and interpretation that they expressed.

Prior Section 8-315. It is not entirely clear what the function of Section 8-315 of prior law was. The section specified that the owner of a security could recover it from a person to whom it had been transferred, if the transferee did not qualify as a bona fide purchaser. It seems to have been intended only to recognize that securities, like any other form of personal property, are governed by the general principle of property law that an owner can recover property from a person to whom it has been transferred under circumstances that did not cut off the owner's claim. Although many other Articles of the UCC deal with cut-off rules, Article 8 was the only one that included an affirmative statement of the rights of an owner to recover her property. It seems wiser to adopt the same approach as in Articles 2, 3, 7, and 9, and leave this point to other law. Accordingly, Section 8-315 is deleted in Revised Article 8, without, of course, implying rejection of the nearly self-evident rule that it sought to express.

Prior Section 8-407. This section, entitled "Exchangeability of Securities," seemed to say that holders of securities had the right to cause issuers to convert them back and forth from certificated to uncertificated form. The provision, however, applied only if the issuer "regularly maintains a system for issuing the class of securities involved under which both certificated and uncertificated securities are regularly issued to the category of owners, which includes the person in whose name the new security is to be registered." The provision seems unnecessary, since it applied only if the issuer decided that it should. The matter can be covered by agreement or corporate charter or by-laws.

OFFICIAL COMMENTS - ARTICLE 8

Official Comment [§ 8-102](#)

1. "Adverse claim." The definition of the term "adverse claim" has two components. First, the term refers only to property interests. Second, the term means not merely that a person has a property interest in a [financial asset](#) but that it is a violation of the claimant's property interest for the other person to hold or transfer the [security](#) or other financial asset.

The term adverse claim is not, of course, limited to ownership rights, but extends to other property interests established by other law. A security interest, for example, would be an adverse claim with respect to a transferee from the debtor since any effort by the secured party to enforce the security interest against the property would be an interference with the transferee's interest.

The definition of adverse claim in the prior version of Article 8 might have been read to suggest that any wrongful action concerning a security, even a simple breach of contract, gave rise to an adverse claim. Insofar as such cases as *Fallon v. Wall Street Clearing Corp.*, 586 N.Y.S.2d 953, 182 A.D.2d 245, (1992) and *Pentech Intl. v. Wall St. Clearing Co.*, 983 F.2d 441 (2d Cir. 1993), were based on that view, they are rejected by the new definition which explicitly limits the term adverse claim to property interests. Suppose, for example, that A contracts to sell or deliver securities to B, but fails to do so and instead sells or pledges the securities to C. B, the promisee, has an action against A for breach of contract, but absent unusual circumstances the action for breach would not give rise to a property interest in the securities. Accordingly, B does not have an adverse claim. An adverse claim might, however, be based upon principles of equitable remedies that give rise to property claims. It would, for example, cover a right established by other law to rescind a transaction in which securities were transferred. Suppose, for example, that A holds securities and is induced by B's fraud to transfer them to B. Under the law of contract or restitution, A may have a right to rescind the transfer, which gives A a property claim to the securities. If so, A has an adverse claim to the securities in B's hands. By contrast, if B had committed no fraud, but had merely committed a breach of contract in connection with the transfer from A to B, A may have only a right to damages for breach, not a right to rescind. In that case, A would not have an adverse claim to the securities in B's hands.

2. "Bearer form." The definition of "bearer form" has remained substantially unchanged since the early drafts of the original version of Article 8. The requirement that the certificate be payable to bearer by its terms rather than by an [indorsement](#) has the effect of preventing instruments governed by other law, such as chattel paper or Article 3 negotiable instruments, from being inadvertently swept into the Article 8 definition of [security](#) merely by virtue of blank indorsements. Although the other elements of the definition of security in Section 8-102(a)(14) probably suffice for that purpose in any event, the language used in the prior version of Article 8 has been retained.

3. "Broker." Broker is defined by reference to the definitions of broker and dealer in the federal [securities](#) laws. The only difference is that banks, which are excluded from the federal securities law definition, are included in the Article 8 definition when they perform functions that would bring them within the federal securities law definition if it did not have the clause excluding banks. The definition covers both those who act as agents ("brokers" in securities parlance) and those who act as principals ("dealers" in securities parlance). Since the definition refers to persons "defined" as brokers or dealers under the federal securities law, rather than to persons required to "register" as brokers or dealers under the federal securities law, it covers not only registered brokers and dealers but also those exempt from the registration requirement, such as purely intrastate brokers. The only substantive rules that turn on the defined term broker are one provision of the section on warranties, Section [8-108\(i\)](#), and the special perfection rule in Article 9 for security interests granted by brokers or securities intermediaries, Section [9-309\(10\)](#).

4. "Certificated security." The term "certificated security" means a security that is represented by a [security certificate](#).

5. "Clearing corporation." The definition of clearing corporation limits its application to entities that are subject to a rigorous regulatory framework. Accordingly, the definition includes only federal reserve banks, persons who are registered as "clearing agencies" under the federal securities laws (which impose a comprehensive system of regulation of the activities and rules of clearing agencies), and other entities subject to a comparable system of regulatory oversight.

6. "Communicate." The term "communicate" assures that the Article 8 rules will be sufficiently flexible to adapt to changes in information technology. Sending a signed writing always suffices as a communication, but the parties can agree that a different means of transmitting information is to be used. Agreement is defined in Section [1-201\(3\)](#) as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance." Thus, use of an information transmission method might be found to be authorized by agreement, even though the parties have not explicitly so specified in a formal agreement. The term communicate is used in Sections 8-102(a)(7) (definition of [entitlement order](#)), 8-102(a)(11) (definition of [instruction](#)), and 8-403 (demand that [issuer](#) not register transfer).

7. "Entitlement holder." This term designates those who hold [financial assets](#) through intermediaries in the indirect holding system. Because many of the rules of Part 5 impose duties on securities intermediaries in favor of entitlement holders, the definition of entitlement holder is, in most cases, limited to the person specifically designated as such on the records of the intermediary. The last sentence of the definition covers the relatively unusual cases where a person may acquire a [security entitlement](#) under Section [8-501](#) even though the person may not be specifically designated as an entitlement holder on the records of the [securities intermediary](#).

A person may have an interest in a security entitlement, and may even have the right to give [entitlement orders](#) to the [securities intermediary](#) with respect to it,

even though the person is not the [entitlement holder](#). For example, a person who holds securities through a [securities account](#) in its own name may have given discretionary trading authority to another person, such as an investment adviser. Similarly, the control provisions in Section [8-106](#) and the related provisions in Article 9 are designed to facilitate transactions in which a person who holds securities through a securities account uses them as collateral in an arrangement where the securities intermediary has agreed that if the secured party so directs the intermediary will dispose of the positions. In such arrangements, the debtor remains the entitlement holder but has agreed that the secured party can initiate entitlement orders. Moreover, an entitlement holder may be acting for another person as a nominee, agent, trustee, or in another capacity. Unless the entitlement holder is itself acting as a securities intermediary for the other person, in which case the other person would be an entitlement holder with respect to the securities entitlement, the relationship between an entitlement holder and another person for whose benefit the entitlement holder holds a securities entitlement is governed by other law.

8. "Entitlement order." This term is defined as a notification [communicated](#) to a [securities intermediary](#) directing transfer or redemption of the [financial asset](#) to which an [entitlement holder](#) has a security entitlement. The term is used in the rules for the indirect holding system in a fashion analogous to the use of the terms "[indorsement](#)" and "[instruction](#)" in the rules for the direct holding system. If a person directly holds a certificated security in [registered form](#) and wishes to transfer it, the means of transfer is an indorsement. If a person directly holds an [uncertificated security](#) and wishes to transfer it, the means of transfer is an instruction. If a person holds a [security entitlement](#), the means of disposition is an entitlement order. An entitlement order includes a direction under Section [8-508](#) to the securities intermediary to transfer a financial asset to the account of the entitlement holder at another financial intermediary or to cause the financial asset to be transferred to the entitlement holder in the direct holding system (e.g., the delivery of a securities certificate registered in the name of the former entitlement holder). As noted in Comment 7, an entitlement order need not be initiated by the entitlement holder in order to be [effective](#), so long as the entitlement holder has authorized the other party to initiate entitlement orders. See Section [8-107\(b\)](#).

9. "Financial asset." The definition of "financial asset," in conjunction with the definition of "securities account" in Section [8-501](#), sets the scope of the indirect holding system rules of Part 5 of Revised Article 8. The Part 5 rules apply not only to [securities](#) held through intermediaries, but also to other financial assets held through intermediaries. The term financial asset is defined to include not only securities but also a broader category of obligations, shares, participations, and interests.

Having separate definitions of security and [financial asset](#) makes it possible to separate the question of the proper scope of the traditional Article 8 rules from the question of the proper scope of the new indirect holding system rules. Some forms of financial assets should be covered by the indirect holding system rules of Part 5, but not by the rules of Parts 2, 3, and 4. The term financial asset is used to cover such property. Because the term [security entitlement](#) is defined in terms of financial assets rather than securities, the rules concerning security

entitlements set out in Part 5 of Article 8 and in Revised Article 9 apply to the broader class of financial assets.

The fact that something does or could fall within the definition of [financial asset](#) does not, without more, trigger Article 8 coverage. The indirect holding system rules of Revised Article 8 apply only if the financial asset is in fact held in a [securities account](#), so that the interest of the person who holds the financial asset through the securities account is a security entitlement. Thus, questions of the scope of the indirect holding system rules cannot be framed as "Is such-and-such a 'financial asset' under Article 8?" Rather, one must analyze whether the relationship between an institution and a person on whose behalf the institution holds an asset falls within the scope of the term securities account as defined in Section [8-501](#). That question turns in large measure on whether it makes sense to apply the Part 5 rules to the relationship.

The term [financial asset](#) is used to refer both to the underlying asset and the particular means by which ownership of that asset is evidenced. Thus, with respect to a certificated security, the term financial asset may, as context requires, refer either to the interest or obligation of the issuer or to the [security certificate](#) representing that interest or obligation. Similarly, if a person holds a security or other financial asset through a [securities account](#), the term financial asset may, as context requires, refer either to the underlying asset or to the person's security entitlement.

10. "Good faith." Section [1-203](#) provides that "Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance or enforcement." Section [1-201\(b\)\(20\)](#) defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing." The reference to commercial standards makes clear that assessments of conduct are to be made in light of the commercial setting. The substantive rules of Article 8 have been drafted to take account of the commercial circumstances of the securities holding and processing system. For example, Section [8-115](#) provides that a [securities intermediary](#) acting on an [effective entitlement order](#), or a [broker](#) or other agent acting as a conduit in a securities transaction, is not liable to an adverse claimant, unless the claimant obtained legal process or the intermediary acted in collusion with the wrongdoer. This, and other similar provisions, see Sections [8-404](#) and [8-503\(e\)](#), do not depend on notice of adverse claims, because it would impair rather than advance the interest of investors in having a sound and efficient securities clearance and settlement system to require intermediaries to investigate the propriety of the transactions they are processing. The good faith obligation does not supplant the standards of conduct established in provisions of this kind.

In Revised Article 8, the definition of [good faith](#) is not germane to the question whether a purchaser takes free from adverse claims. The rules on such questions as whether a purchaser who takes in suspicious circumstances is disqualified from [protected purchaser](#) status are treated not as an aspect of good faith but directly in the rules of Section [8-105](#) on notice of adverse claims.

11. "Indorsement" is defined as a signature made on a [security certificate](#) or separate document for purposes of transferring or redeeming the security. The definition is adapted from the language of Section 8-308(1) of the prior version

and from the definition of indorsement in the Negotiable Instruments Article, see Section [3-204\(a\)](#). The definition of indorsement does not include the requirement that the signature be made by an [appropriate person](#) or be authorized. Those questions are treated in the separate substantive provision on whether the indorsement is [effective](#), rather than in the definition of indorsement. See Section [8-107](#).

12. "Instruction" is defined as a notification [communicated](#) to the [issuer](#) of an [uncertificated security](#) directing that transfer be registered or that the security be redeemed. Instructions are the analog for uncertificated securities of indorsements of [certificated securities](#).

13. "Registered form." The definition of "registered form" is substantially the same as in the prior version of Article 8. Like the definition of bearer form, it serves primarily to distinguish Article 8 [securities](#) from instruments governed by other law, such as Article 3.

14. "Securities intermediary." A "securities intermediary" is a person that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity. The most common examples of securities intermediaries would be clearing corporations holding securities for their participants, banks acting as securities custodians, and brokers holding securities on behalf of their customers. Clearing corporations are listed separately as a category of securities intermediary in subparagraph (i) even though in most circumstances they would fall within the general definition in subparagraph (ii). The reason is to simplify the analysis of arrangements such as the NSCC-DTC system in which NSCC performs the comparison, clearance, and netting function, while DTC acts as the depository. Because NSCC is a registered clearing agency under the federal securities laws, it is a [clearing corporation](#) and hence a securities intermediary under Article 8, regardless of whether it is at any particular time or in any particular aspect of its operations holding securities on behalf of its participants.

The terms [securities intermediary](#) and [broker](#) have different meanings. Broker means a person engaged in the business of buying and selling securities, as agent for others or as principal. Securities intermediary means a person maintaining securities accounts for others. A stockbroker, in the colloquial sense, may or may not be acting as a securities intermediary.

The definition of [securities intermediary](#) includes the requirement that the person in question is "acting in the capacity" of maintaining securities accounts for others. This is to take account of the fact that a particular entity, such as a bank, may act in many different capacities in securities transactions. A bank may act as a transfer agent for [issuers](#), as a securities custodian for institutional investors and private investors, as a dealer in government securities, as a lender taking securities as collateral, and as a provider of general payment and collection services that might be used in connection with securities transactions. A bank that maintains securities accounts for its customers would be a securities intermediary with respect to those accounts; but if it takes a pledge of securities from a borrower to secure a loan, it is not thereby acting as a securities intermediary with respect to the pledged securities, since it holds them for its own account rather than for a customer. In other circumstances, those two functions might be combined. For example, if the bank is a government

securities dealer it may maintain securities accounts for customers and also provide the customers with margin credit to purchase or carry the securities, in much the same way that brokers provide margin loans to their customers.

15. "Security." The definition of "security" has three components. First, there is the subparagraph (i) test that the interest or obligation be fully transferable, in the sense that the [issuer](#) either maintains transfer books or the obligation or interest is represented by a certificate in bearer or [registered form](#). Second, there is the subparagraph (ii) test that the interest or obligation be divisible, that is, one of a class or series, as distinguished from individual obligations of the sort governed by ordinary contract law or by Article 3. Third, there is the subparagraph (iii) functional test, which generally turns on whether the interest or obligation is, or is of a type, dealt in or traded on securities markets or securities exchanges. There is, however, an "opt-in" provision in subparagraph (iii) which permits the issuer of any interest or obligation that is "a medium of investment" to specify that it is a security governed by Article 8.

The divisibility test of subparagraph (ii) applies to the security -- that is, the underlying intangible interest -- not the means by which that interest is evidenced. Thus, securities issued in book-entry only form meet the divisibility test because the underlying intangible interest is divisible via the mechanism of the indirect holding system. This is so even though the [clearing corporation](#) is the only eligible direct holder of the security.

The third component, the functional test in subparagraph (iii), provides flexibility while ensuring that the Article 8 rules do not apply to interests or obligations in circumstances so unconnected with the securities markets that parties are unlikely to have thought of the possibility that Article 8 might apply. Subparagraph (iii)(A) covers interests or obligations that either are dealt in or traded on securities exchanges or securities markets, or are of a type dealt in or traded on securities exchanges or securities markets. The "is dealt in or traded on" phrase eliminates problems in the characterization of new forms of securities which are to be traded in the markets, even though no similar type has previously been dealt in or traded in the markets. Subparagraph (iii)(B) covers the broader category of media for investment, but it applies only if the terms of the interest or obligation specify that it is an Article 8 security. This opt-in provision allows for deliberate expansion of the scope of Article 8.

Section [8-103](#) contains additional rules on the treatment of particular interests as [securities](#) or [financial assets](#).

16. "Security certificate." The term "security" refers to the underlying asset, e.g., 1000 shares of common stock of Acme, Inc. The term "security certificate" refers to the paper certificates that have traditionally been used to embody the underlying intangible interest.

17. "Security entitlement" means the rights and property interest of a person who holds securities or other [financial assets](#) through a [securities intermediary](#). A security entitlement is both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary. A security entitlement is not, however, a specific property interest in any financial asset held by the securities intermediary or by the [clearing corporation](#) through

which the securities intermediary holds the financial asset. See Sections [8-104\(c\)](#) and [8-503](#). The formal definition of security entitlement set out in subsection (a)(17) of this section is a cross-reference to the rules of Part 5. In a sense, then, the entirety of Part 5 is the definition of security entitlement. The Part 5 rules specify the rights and property interest that comprise a security entitlement.

18. "Uncertificated security." The term "uncertificated security" means a security that is not represented by a [security certificate](#). For uncertificated securities, there is no need to draw any distinction between the underlying asset and the means by which a direct holder's interest in that asset is evidenced. Compare "certificated security" and "security certificate."

Definitional Cross References

"Agreement" § [1-201\(b\)\(3\)](#)

"Bank" § [1-201\(b\)\(4\)](#)

"Person" § [1-201\(b\)\(27\)](#)

"Send" § [1-201\(b\)\(36\)](#)

"Signed" § [1-201\(b\)\(37\)](#)

"Writing" § [1-201\(b\)\(43\)](#)

Official Comment [§ 8-103](#)

1. This section contains rules that supplement the definitions of "[financial asset](#)" and "[security](#)" in Section [8-102](#). The Section [8-102](#) definitions are worded in general terms, because they must be sufficiently comprehensive and flexible to cover the wide variety of investment products that now exist or may develop. The rules in this section are intended to foreclose interpretive issues concerning the application of the general definitions to several specific investment products. No implication is made about the application of the Section [8-102](#) definitions to investment products not covered by this section.

2. Subsection (a) establishes an unconditional rule that ordinary corporate stock is a [security](#). That is so whether or not the particular issue is dealt in or traded on securities exchanges or in securities markets. Thus, shares of closely held corporations are Article 8 securities.

3. Subsection (b) establishes that the Article 8 term "[security](#)" includes the various forms of the investment vehicles offered to the public by investment companies registered as such under the federal Investment Company Act of 1940, as amended. This clarification is prompted principally by the fact that the typical transaction in shares of open-end investment companies is an issuance or redemption, rather than a transfer of shares from one person to another as is the case with ordinary corporate stock. For similar reasons, the definitions of [indorsement](#), [instruction](#), and [entitlement order](#) in Section [8-102](#) refer to

"redemptions" as well as "transfers," to ensure that the Article 8 rules on such matters as signature guaranties, Section [8-306](#), assurances, Sections [8-402](#) and [8-507](#), and effectiveness, Section [8-107](#), apply to directions to redeem mutual fund shares. The exclusion of insurance products is needed because some insurance company separate accounts are registered under the Investment Company Act of 1940, but these are not traded under the usual Article 8 mechanics.

4. Subsection (c) is designed to foreclose interpretive questions that might otherwise be raised by the application of the "of a type" language of Section [8-102\(a\)\(15\)\(iii\)](#) to partnership interests. Subsection (c) establishes the general rule that partnership interests or shares of limited liability companies are not Article 8 securities unless they are in fact dealt in or traded on securities exchanges or in securities markets. The [issuer](#), however, may explicitly "opt-in" by specifying that the interests or shares are securities governed by Article 8. Partnership interests or shares of limited liability companies are included in the broader term "[financial asset](#)." Thus, if they are held through a [securities account](#), the indirect holding system rules of Part 5 apply, and the interest of a person who holds them through such an account is a [security entitlement](#).

5. Subsection (d) deals with the line between Article 3 negotiable instruments and Article 8 investment securities. It continues the rule of the prior version of Article 8 that a writing that meets the Article 8 definition is covered by Article 8 rather than Article 3, even though it also meets the definition of negotiable instrument. However, subsection (d) provides that an Article 3 negotiable instrument is a "[financial asset](#)" so that the indirect holding system rules apply if the instrument is held through a [securities intermediary](#). This facilitates making items such as money market instruments eligible for deposit in clearing corporations.

6. Subsection (e) is included to clarify the treatment of investment products such as traded stock options, which are treated as [financial assets](#) but not [securities](#). Thus, the indirect holding system rules of Part 5 apply, but the direct holding system rules of Parts 2, 3, and 4 do not.

7. Subsection (f) excludes commodity contracts from all of Article 8. However, under Article 9, commodity contracts are included in the definition of "investment property." Therefore, the Article 9 rules on security interests in investment property do apply to security interests in commodity positions. See Section [9-102](#) and Comment 6 thereto. "Commodity contract" is defined in Section [9-102\(a\)\(15\)](#).

Definitional Cross References

"Clearing corporation" § [8-102\(a\)\(5\)](#)

"Commodity contract" § [9-102\(a\)\(15\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment § [8-104](#)

1. This section lists the ways in which interests in securities and other [financial assets](#) are acquired under Article 8. In that sense, it describes the scope of Article 8. Subsection (a) describes the two ways that a person may acquire a security or interest therein under this Article: (1) by [delivery](#) (Section [8-301](#)), and (2) by acquiring a [security entitlement](#). Each of these methods is described in detail in the relevant substantive provisions of this Article. Part 3, beginning with the definition of "delivery" in Section [8-301](#), describes how interests in securities are acquired in the direct holding system. Part 5, beginning with the rules of Section [8-501](#) on how security entitlements are acquired, describes how interests in securities are acquired in the indirect holding system.

Subsection (b) specifies how a person may acquire an interest under Article 8 in a [financial asset](#) other than a security. This Article deals with financial assets other than securities only insofar as they are held in the indirect holding system. For example, a bankers' acceptance falls within the definition of "financial asset," so if it is held through a [securities account](#) the [entitlement holder's](#) right to it is a security entitlement governed by Part 5. The bankers' acceptance itself, however, is a negotiable instrument governed by Article 3, not by Article 8. Thus, the provisions of Parts 2, 3, and 4 of this Article that deal with the rights of direct holders of securities are not applicable. Article 3, not Article 8, specifies how one acquires a direct interest in a bankers' acceptance. If a bankers' acceptance is delivered to a [clearing corporation](#) to be held for the account of the clearing corporation's participants, the clearing corporation becomes the holder of the bankers' acceptance under the Article 3 rules specifying how negotiable instruments are transferred. The rights of the clearing corporation's participants, however, are governed by Part 5 of this Article.

2. The distinction in usage in Article 8 between the term "security" (and its correlatives "[security certificate](#)" and "[uncertificated security](#)") on the one hand, and "[security entitlement](#)" on the other, corresponds to the distinction between the direct and indirect holding systems. For example, with respect to [certificated securities](#) that can be held either directly or through intermediaries, obtaining possession of a [security certificate](#) and acquiring a security entitlement are both means of holding the underlying security. For many other purposes, there is no need to draw a distinction between the means of holding. For purposes of commercial law analysis, however, the form of holding may make a difference. Where an item of property can be held in different ways, the rules on how one deals with it, including how one transfers it or how one grants a security interest in it, differ depending on the form of holding.

Although a security entitlement is means of holding the underlying security or other [financial asset](#), a person who has a security entitlement does not have any direct claim to a specific asset in the possession of the [securities intermediary](#). Subsection (c) provides explicitly that a person who acquires a security entitlement is a "purchaser" of any security, security entitlement, or other financial asset held by the securities intermediary only in the sense that under Section [8-503](#) a security entitlement is treated as a *sui generis* form of property interest.

3. Subsection (d) is designed to ensure that parties will retain their expected legal rights and duties under Revised Article 8. One of the major changes made by the revision is that the rules for the indirect holding system are stated in terms of the "security entitlements" held by investors, rather than speaking of them as holding direct interests in securities. Subsection (d) is designed as a translation rule to eliminate problems of co-ordination of terminology, and facilitate the continued use of systems for the efficient handling of securities and [financial assets](#) through securities intermediaries and clearing corporations. The efficiencies of a [securities intermediary](#) or [clearing corporation](#) are, in part, dependent on the ability to transfer securities credited to securities accounts in the intermediary or clearing corporation to the account of an [issuer](#), its agent, or other person by book entry in a manner that permits exchanges, redemptions, conversions, and other transactions (which may be governed by pre-existing or new agreements, constitutional documents, or other instruments) to occur and to avoid the need to withdraw from immobilization in an intermediary or clearing corporation physical securities in order to deliver them for such purposes. Existing corporate charters, indentures and like documents may require the "presentation," "surrender," "delivery," or "transfer" of securities or [security certificates](#) for purposes of exchange, redemption, conversion or other reason. Likewise, documents may use a wide variety of terminology to describe, in the context for example of a tender or exchange offer, the means of putting the offeror or the issuer or its agent in possession of the security. Subsection (d) takes the place of provisions of prior law which could be used to reach the legal conclusion that book-entry transfers are equivalent to physical delivery to the person to whose account the book entry is credited.

Definitional Cross References

"Delivery" § [8-301](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Person" § [1-201\(30\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

Official Comment [§ 8-105](#)

1. The rules specifying whether adverse claims can be asserted against persons who acquire securities or security entitlements, Sections 8-303, 8-502, and 8-510, provide that one is protected against an adverse claim only if one takes without notice of the claim. This section defines [notice of an adverse claim](#).

The general Article 1 definition of "notice" in Section [1-201\(25\)](#) -- which provides that a person has notice of a fact if "from all the facts and circumstances known to him at the time in question he has reason to know that it exists" -- does not apply to the interpretation of "notice of adverse claims." The Section [1-201\(25\)](#)

definition of "notice" does, however, apply to usages of that term and its cognates in Article 8 in contexts other than notice of adverse claims.

2. This section must be interpreted in light of the definition of "adverse claim" in Section [8-102\(a\)\(1\)](#). "Adverse claim" does not include all circumstances in which a third party has a property interest in [securities](#), but only those situations where a security is transferred in violation of the claimant's property interest. Therefore, awareness that someone other than the transferor has a property interest is not [notice of an adverse claim](#). The transferee must be aware that the transfer violates the other party's property interest. If A holds securities in which B has some form of property interest, and A transfers the securities to C, C may know that B has an interest, but infer that A is acting in accordance with A's obligations to B. The mere fact that C knew that B had a property interest does not mean that C had notice of an adverse claim. Whether C had notice of an adverse claim depends on whether C had sufficient awareness that A was acting in violation of B's property rights. The rule in subsection (b) is a particularization of this general principle.

3. Paragraph (a)(1) provides that a person has notice of an adverse claim if the person has knowledge of the adverse claim. Knowledge is defined in Section [1-201\(25\)](#) as actual knowledge.

4. Paragraph (a)(2) provides that a person has notice of an adverse claim if the person is aware of a significant probability that an adverse claim exists and deliberately avoids information that might establish the existence of the adverse claim. This is intended to codify the "willful blindness" test that has been applied in such cases. See *May v. Chapman*, 16 M. & W. 355, 153 Eng. Rep. 1225 (1847); *Goodman v. Simonds*, 61 U.S. 343 (1857).

The first prong of the willful blindness test of paragraph (a)(2) turns on whether the person is aware facts sufficient to indicate that there is a significant probability that an adverse claim exists. The "awareness" aspect necessarily turns on the actor's state of mind. Whether facts known to a person make the person aware of a "significant probability" that an adverse claim exists turns on facts about the world and the conclusions that would be drawn from those facts, taking account of the experience and position of the person in question. A particular set of facts might indicate a significant probability of an adverse claim to a professional with considerable experience in the usual methods and procedures by which securities transactions are conducted, even though the same facts would not indicate a significant probability of an adverse claim to a non-professional.

The second prong of the willful blindness test of paragraph (a)(2) turns on whether the person "deliberately avoids information" that would establish the existence of the adverse claim. The test is the character of the person's response to the information the person has. The question is whether the person deliberately failed to seek further information because of concern that suspicions would be confirmed.

Application of the "deliberate avoidance" test to a transaction by an organization focuses on the knowledge and the actions of the individual or individuals conducting the transaction on behalf of the organization. Thus, an organization

that purchases a [security](#) is not willfully blind to an adverse claim unless the officers or agents who conducted that purchase transaction are willfully blind to the adverse claim. Under the two prongs of the willful blindness test, the individual or individuals conducting a transaction must know of facts indicating a substantial probability that the adverse claim exists and deliberately fail to seek further information that might confirm or refute the indication. For this purpose, information known to individuals within an organization who are not conducting or aware of a transaction, but not forwarded to the individuals conducting the transaction, is not pertinent in determining whether the individuals conducting the transaction had knowledge of a substantial probability of the existence of the adverse claim. Cf. Section [1-201\(27\)](#). An organization may also "deliberately avoid information" if it acts to preclude or inhibit transmission of pertinent information to those individuals responsible for the conduct of purchase transactions.

5. Paragraph (a)(3) provides that a person has [notice of an adverse claim](#) if the person would have learned of the adverse claim by conducting an investigation that is required by other statute or regulation. This rule applies only if there is some other statute or regulation that explicitly requires persons dealing with [securities](#) to conduct some investigation. The federal securities laws require that brokers and banks, in certain specified circumstances, check with a stolen securities registry to determine whether securities offered for sale or pledge have been reported as stolen. If securities that were listed as stolen in the registry are taken by an institution that failed to comply with requirement to check the registry, the institution would be held to have notice of the fact that they were stolen under paragraph (a)(3). Accordingly, the institution could not qualify as a [protected purchaser](#) under Section [8-303](#). The same result has been reached under the prior version of Article 8. See *First Nat'l Bank of Cicero v. Lewco Securities*, 860 F.2d 1407 (7th Cir. 1988).

6. Subsection (b) provides explicitly for some situations involving purchase from one described or identifiable as a representative. Knowledge of the existence of the representative relation is not enough in itself to constitute "notice of an adverse claim" that would disqualify the purchaser from protected purchaser status. A purchaser may take a [security](#) on the inference that the representative is acting properly. Knowledge that a security is being transferred to an individual account of the representative or that the proceeds of the transaction will be paid into that account is not sufficient to constitute "notice of an adverse claim," but knowledge that the proceeds will be applied to the personal indebtedness of the representative is. See *State Bank of Binghamton v. Bache*, 162 Misc. 128, 293 N.Y.S. 667 (1937).

7. Subsection (c) specifies whether a purchaser of a "stale" [security](#) is charged with [notice of adverse claims](#), and therefore disqualified from [protected purchaser](#) status under Section [8-303](#). The fact of "staleness" is viewed as notice of certain defects after the lapse of stated periods, but the maturity of the security does not operate automatically to affect holders' rights. The periods of time here stated are shorter than those appearing in the provisions of this Article on staleness as notice of defects or defenses of an [issuer](#) (Section [8-203](#)) since a purchaser who takes a security after funds or other securities are available for its redemption has more reason to suspect claims of ownership than issuer's defenses. An owner will normally turn in a security rather than transfer it at such

a time. Of itself, a default never constitutes notice of a possible adverse claim. To provide otherwise would not tend to drive defaulted securities home and would serve only to disrupt current financial markets where many defaulted securities are actively traded. Unpaid or overdue coupons attached to a bond do not bring it within the operation of this subsection, though they may be relevant under the general test of notice of adverse claims in subsection (a).

8. Subsection (d) provides the owner of a certificated security with a means of protection while a [security certificate](#) is being sent in for redemption or exchange. The owner may endorse it "for collection" or "for surrender," and this constitutes notice of the owner's claims, under subsection (d).

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Bearer form" § [8-102\(a\)\(2\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Knowledge" § [1-201\(25\)](#)

"Person" § [1-201\(30\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Representative" § [1-201\(35\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-106](#)

1. The concept of "control" plays a key role in various provisions dealing with the rights of purchasers, including secured parties. See Sections [8-303](#) ([protected purchasers](#)); [8-503\(e\)](#) (purchasers from securities intermediaries); [8-510](#) (purchasers of security entitlements from [entitlement holders](#)); [9-314](#) (perfection of security interests); [9-328](#) (priorities among conflicting security interests).

Obtaining "control" means that the purchaser has taken whatever steps are necessary, given the manner in which the [securities](#) are held, to place itself in a position where it can have the securities sold, without further action by the owner.

2. Subsection (a) provides that a purchaser obtains "control" with respect to a certificated security in bearer form by taking "[delivery](#)," as defined in Section [8-301](#). Subsection (b) provides that a purchaser obtains "control" with respect to a

certificated security in [registered form](#) by taking "delivery," as defined in Section [8-301](#), provided that the [security certificate](#) has been indorsed to the purchaser or in blank. Section [8-301](#) provides that delivery of a certificated security occurs when the purchaser obtains possession of the security certificate, or when an agent for the purchaser (other than a [securities intermediary](#)) either acquires possession or acknowledges that the agent holds for the purchaser.

3. Subsection (c) specifies the means by which a purchaser can obtain control of [uncertificated securities](#) which the transferor holds directly. Three mechanisms are possible.

Under subsection (c)(1), securities can be "delivered" to a purchaser. Section [8-301\(b\)](#) provides that "delivery" of an uncertificated security occurs when the purchaser becomes the registered holder. So far as the [issuer](#) is concerned, the purchaser would then be entitled to exercise all rights of ownership. See Section [8-207](#). As between the parties to a purchase transaction, however, the rights of the purchaser are determined by their contract. Cf. Section [9-202](#). Arrangements covered by this paragraph are analogous to arrangements in which bearer certificates are delivered to a secured party -- so far as the issuer or any other parties are concerned, the secured party appears to be the outright owner, although it is in fact holding as collateral property that belongs to the debtor.

Under subsection (c)(2), a purchaser has control if the issuer has agreed to act on the [instructions](#) of the purchaser, even though the owner remains listed as the registered owner. The issuer, of course, would be acting wrongfully against the registered owner if it entered into such an agreement without the consent of the registered owner. Subsection (g) makes this point explicit. The subsection (c)(2) provision makes it possible for issuers to offer a service akin to the registered pledge device of the 1978 version of Article 8, without mandating that all issuers offer that service.

4. Subsection (d) specifies the means by which a purchaser can obtain control over a [security entitlement](#). Two mechanisms are possible, analogous to those provided in subsection (c) for [uncertificated securities](#). Under subsection (d)(1), a purchaser has control if it is the [entitlement holder](#). This subsection would apply whether the purchaser holds through the same intermediary that the debtor used, or has the securities position transferred to its own intermediary.

Subsection (d)(2) provides that a purchaser has control if the [securities intermediary](#) has agreed to act on [entitlement orders](#) originated by the purchaser if no further consent by the entitlement holder is required. Under subsection (d)(2), control may be achieved even though the original entitlement holder remains as the entitlement holder. Finally, a purchaser may obtain control under subsection (d)(3) if another person has control and the person acknowledges that it has control on the purchaser's behalf. Control under subsection (d)(3) parallels the delivery of certificated securities and uncertificated securities under Section [8-301](#). Of course, the acknowledging person cannot be the debtor.

This section specifies only the minimum requirements that such an arrangement must meet to confer "control"; the details of the arrangement can be specified by agreement. The arrangement might cover all of the positions in a particular account or subaccount, or only specified positions. There is no requirement that

the control party's right to give entitlement orders be exclusive. The arrangement might provide that only the control party can give entitlement orders, or that either the entitlement holder or the control party can give entitlement orders. See subsection (f).

The following examples illustrate the application of subsection (d):

Example 1. Debtor grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Alpha Bank also has an account with Able. Debtor instructs Able to transfer the shares to Alpha Bank, and Able does so by crediting the shares to Alpha's account. Alpha has control of the 1000 shares under subsection (d)(1). Although Debtor may have become the beneficial owner of the new securities entitlement, as between Debtor and Alpha, Able has agreed to act on Alpha's entitlement orders because, as between Able and Alpha, Able has become the [entitlement holder](#). See Section [8-506](#).

Example 2. Debtor grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Alpha Bank does not have an account with Able. Alpha Bank uses Beta Bank as its securities custodian. Debtor instructs Able to transfer the shares to Beta Bank, for the account of Alpha Bank, and Able does so. Alpha Bank has control of the 1000 shares under subsection (d)(1). As in Example 1, although Debtor may have become the beneficial owner of the new securities entitlement, as between Debtor and Alpha, Beta has agreed to act on Alpha's entitlement orders because, as between Beta and Alpha, Alpha has become the [entitlement holder](#).

Example 3. Debtor grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Debtor, Able, and Alpha enter into an agreement under which Debtor will continue to receive dividends and distributions, and will continue to have the right to direct dispositions, but Alpha also has the right to direct dispositions. Alpha has control of the 1000 shares under subsection (d)(2).

Example 4. Able & Co., a securities dealer, grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Able holds through an account with Clearing Corporation. Able causes Clearing Corporation to transfer the shares into Alpha's account at Clearing Corporation. As in Example 1, Alpha has control of the 1000 shares under subsection (d)(1).

Example 5. Able & Co., a securities dealer, grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Able holds through an account with Clearing Corporation. Alpha does not have an account with Clearing Corporation. It holds its securities through Beta Bank, which does have an account with Clearing Corporation. Able causes Clearing Corporation to transfer the shares into Beta's account at Clearing Corporation. Beta credits the position to Alpha's account with Beta Bank. As in Example 2, Alpha has control of the 1000 shares under subsection (d)(1).

Example 6. Able & Co. a securities dealer, grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Able holds through an account with Clearing Corporation. Able causes Clearing Corporation to transfer the shares into a pledge account, pursuant to an agreement under which Able will continue to receive dividends, distributions, and the like, but Alpha Bank has the right to direct dispositions. As in Example 3, Alpha has control of the 1000 shares under subsection (d)(2).

Example 7. Able & Co. a securities dealer, grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Able holds through an account with Clearing Corporation. Able, Alpha, and Clearing Corporation enter into an agreement under which Clearing Corporation will act on [instructions](#) from Alpha with respect to the XYZ Co. stock carried in Able's account, but Able will continue to receive dividends, distributions, and the like, and will also have the right to direct dispositions. As in Example 3, Alpha has control of the 1000 shares under subsection (d)(2).

Example 8. Able & Co. a securities dealer, holds a wide range of securities through its account at Clearing Corporation. Able enters into an arrangement with Alpha Bank pursuant to which Alpha provides financing to Able secured by [securities](#) identified as the collateral on lists provided by Able to Alpha on a daily or other periodic basis. Able, Alpha, and Clearing Corporation enter into an agreement under which Clearing Corporation agrees that if at any time Alpha directs Clearing Corporation to do so, Clearing Corporation will transfer any securities from Able's account at Alpha's [instructions](#). Because Clearing Corporation has agreed to act on Alpha's instructions with respect to any securities carried in Able's account, at the moment that Alpha's security interest attaches to securities listed by Able, Alpha obtains control of those securities under subsection (d)(2). There is no requirement that Clearing Corporation be informed of which securities Able has pledged to Alpha.

Example 9. Debtor grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Beta Bank agrees with Alpha to act as Alpha's collateral agent with respect to the security entitlement. Debtor, Able, and Beta enter into an agreement under which Debtor will continue to receive dividends and distributions, and will continue to have the right to direct dispositions, but Beta also has the right to direct dispositions. Because Able has agreed that it will comply with entitlement orders originated by Beta without further consent by Debtor, Beta has control of the security entitlement (see Example 3). Because Beta has control on behalf of Alpha, Alpha also has control under subsection (d)(3). It is not necessary for Able to enter into an agreement directly with Alpha or for Able to be aware of Beta's agency relationship with Alpha.

5. For a purchaser to have "control" under subsection (c)(2) or (d)(2), it is essential that the [issuer](#) or [securities intermediary](#), as the case may be, actually be a party to the agreement. If a debtor gives a secured party a power of attorney authorizing the secured party to act in the name of the debtor, but the issuer or securities intermediary does not specifically agree to this arrangement, the secured party does not have "control" within the meaning of subsection (c)(2) or (d)(2) because the issuer or securities intermediary is not a party to the agreement. The secured party does not have control under subsection (c)(1) or

(d)(1) because, although the power of attorney might give the secured party authority to act on the debtor's behalf as an agent, the secured party has not actually become the registered owner or [entitlement holder](#).

6. Subsection (e) provides that if an interest in a [security entitlement](#) is granted by an [entitlement holder](#) to the [securities intermediary](#) through which the security entitlement is maintained, the securities intermediary has control. A common transaction covered by this provision is a margin loan from a [broker](#) to its customer.

7. The term "control" is used in a particular defined sense. The requirements for obtaining control are set out in this section. The concept is not to be interpreted by reference to similar concepts in other bodies of law. In particular, the requirements for "possession" derived from the common law of pledge are not to be used as a basis for interpreting subsection (c)(2) or (d)(2). Those provisions are designed to supplant the concepts of "constructive possession" and the like. A principal purpose of the "control" concept is to eliminate the uncertainty and confusion that results from attempting to apply common law possession concepts to modern [securities](#) holding practices.

The key to the control concept is that the purchaser has the ability to have the securities sold or transferred without further action by the transferor. There is no requirement that the powers held by the purchaser be exclusive. For example, in a secured lending arrangement, if the secured party wishes, it can allow the debtor to retain the right to make substitutions, to direct the disposition of the [uncertificated security](#) or [security entitlement](#) or otherwise to give instructions or entitlement orders. (As explained in Section [8-102](#), Comment 8, an entitlement order includes a direction under Section 8-508 to the securities intermediary to transfer a financial asset to the account of the entitlement holder at another financial intermediary or to cause the financial asset to be transferred to the entitlement holder in the direct holding system (e.g., by delivery of a securities certificate registered in the name of the former entitlement holder).) Subsection (f) is included to make clear the general point stated in subsections (c) and (d) that the test of control is whether the purchaser has obtained the requisite power, not whether the debtor has retained other powers. There is no implication that retention by the debtor of powers other than those mentioned in subsection (f) is inconsistent with the purchaser having control. Nor is there a requirement that the purchaser's powers be unconditional, provided that further consent of the entitlement holder is not a condition.

Example 10. Debtor grants to Alpha Bank and to Beta Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. By agreement among the parties, Alpha's security interest is senior and Beta's is junior. Able agrees to act on the entitlement orders of either Alpha or Beta. Alpha and Beta each has control under subsection (d)(2). Moreover, Beta has control notwithstanding a term of Able's agreement to the effect that Able's obligation to act on Beta's entitlement orders is conditioned on the Alpha's consent. The crucial distinction is that Able's agreement to act on Beta's entitlement orders is not conditioned on Debtor's further consent.

Example 11. Debtor grants to Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Able agrees to act on the entitlement orders of Alpha, but Alpha's right to give entitlement orders to the securities intermediary is conditioned on the Debtor's default. Alternatively, Alpha's right to give entitlement orders is conditioned upon Alpha's statement to Able that Debtor is in default. Because Able's agreement to act on Beta's entitlement orders is not conditioned on Debtor's further consent, Alpha has control of the securities entitlement under either alternative.

In many situations, it will be better practice for both the securities intermediary and the purchaser to insist that any conditions relating in any way to the entitlement holder be effective only as between the purchaser and the entitlement holder. That practice would avoid the risk that the securities intermediary could be caught between conflicting assertions of the entitlement holder and the purchaser as to whether the conditions in fact have been met. Nonetheless, the existence of unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control.

Definitional Cross References

"Bearer form" § [8-102\(a\)\(2\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Delivery" § [8-301](#)

"Effective" § [8-107](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Entitlement order" § [8-102\(a\)\(8\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment § [8-107](#)

1. This section defines two concepts, "[appropriate person](#)" and "[effective](#)." Effectiveness is a broader concept than appropriate person. For example, if a security or [securities account](#) is registered in the name of Mary Roe, Mary Roe is the "appropriate person," but an [indorsement](#), [instruction](#), or [entitlement order](#) made by John Doe is "effective" if, under agency or other law, Mary Roe is precluded from denying Doe's authority. Treating these two concepts separately facilitates statement of the rules of Article 8 that state the legal effect of an indorsement, instruction, or entitlement order. For example, a [securities intermediary](#) is protected against liability if it acts on an effective entitlement order, but has a duty to comply with an entitlement order only if it is originated by an appropriate person. See Sections [8-115](#) and [8-507](#).

One important application of the "effectiveness" concept is in the direct holding system rules on the rights of purchasers. A purchaser of a certificated security in [registered form](#) can qualify as a [protected purchaser](#) who takes free from adverse claims under Section [8-303](#) only if the purchaser obtains "control." Section [8-106](#) provides that a purchaser of a certificated security in registered form obtains control if there has been an "effective" [indorsement](#).

2. Subsection (a) provides that the term "[appropriate person](#)" covers two categories: (1) the person who is actually designated as the person entitled to the security or [security entitlement](#), and (2) the successor or legal representative of that person if that person has died or otherwise lacks capacity. Other law determines who has power to transfer a security on behalf of a person who lacks capacity. For example, if securities are registered in the name of more than one person and one of the designated persons dies, whether the survivor is the appropriate person depends on the form of tenancy. If the two were registered joint tenants with right of survivorship, the survivor would have that power under other law and thus would be the "appropriate person." If securities are registered in the name of an individual and the individual dies, the law of decedents' estates determines who has power to transfer the decedent's securities. That would ordinarily be the executor or administrator, but if a "small estate statute" permits a widow to transfer a decedent's securities without administration proceedings, she would be the appropriate person. If the registration of a security or a [securities account](#) contains a designation of a death beneficiary under the Uniform Transfer on Death Security Registration Act or comparable legislation, the designated beneficiary would, under that law, have power to transfer upon the person's death and so would be the appropriate person. Article 8 does not contain a list of such representatives, because any list is likely to become outdated by developments in other law.

3. Subsection (b) sets out the general rule that an [indorsement](#), [instruction](#), or [entitlement order](#) is [effective](#) if it is made by the [appropriate person](#) or by a person who has power to transfer under agency law or if the appropriate person is precluded from denying its effectiveness. The control rules in Section [8-106](#) provide for arrangements where a person who holds securities through a [securities intermediary](#), or holds [uncertificated securities](#) directly, enters into a control agreement giving the secured party the right to initiate entitlement orders of instructions. Paragraph 2 of subsection (b) states explicitly that an entitlement order or instruction initiated by a person who has obtained such a control agreement is "effective."

Subsections (c), (d), and (e) supplement the general rule of subsection (b) on effectiveness. The term "representative," used in subsections (c) and (d), is defined in Section [1-201\(35\)](#).

4. Subsection (c) provides that an [indorsement](#), [instruction](#), or [entitlement order](#) made by a representative is effective even though the representative's action is a violation of duties. The following example illustrates this subsection:

Example 1. [Certificated securities](#) are registered in the name of John Doe. Doe dies and Mary Roe is appointed executor. Roe indorses the [security certificate](#) and transfers it to a purchaser in a transaction that is a violation of her duties as executor.

Roe's [indorsement](#) is effective, because Roe is the [appropriate person](#) under subsection (a)(4). This is so even though Roe's transfer violated her obligations as executor. The policies of free transferability of [securities](#) that underlie Article 8 dictate that neither a purchaser to whom Roe transfers the securities nor the [issuer](#) who registers transfer should be required to investigate the terms of the will to determine whether Roe is acting properly. Although Roe's indorsement is effective under this section, her breach of duty may be such that her beneficiary has an adverse claim to the securities that Roe transferred. The question whether that adverse claim can be asserted against purchasers is governed not by this section but by Section [8-303](#). Under Section [8-404](#), the issuer has no duties to an adverse claimant unless the claimant obtains legal process enjoining the issuer from registering transfer.

5. Subsection (d) deals with cases where a [security](#) or a [securities account](#) is registered in the name of a person specifically designated as a representative. The following example illustrates this subsection:

Example 2. [Certificated securities](#) are registered in the name of "John Jones, trustee of the Smith Family Trust." John Jones is removed as trustee and Martha Moe is appointed successor trustee. The securities, however, are not reregistered, but remain registered in the name of "John Jones, trustee of the Smith Family Trust." Jones indorses the [security certificate](#) and transfers it to a purchaser.

Subsection (d) provides that an [indorsement](#) by John Jones as trustee is [effective](#) even though Jones is no longer serving in that capacity. Since the [securities](#) were registered in the name of "John Jones, trustee of the Smith Family Trust," a purchaser, or the [issuer](#) when called upon to register transfer, should be entitled to assume without further inquiry that Jones has the power to act as trustee for the Smith Family Trust.

Note that subsection (d) does not apply to a case where the security or [securities account](#) is registered in the name of principal rather than the representative as such. The following example illustrates this point:

Example 3. [Certificated securities](#) are registered in the name of John Doe. John Doe dies and Mary Roe is appointed executor. The securities are not reregistered in the name of Mary Roe as executor. Later, Mary Roe is removed as executor and Martha Moe is appointed as her successor. After being removed, Mary Roe

indorses the [security certificate](#) that is registered in the name of John Doe and transfers it to a purchaser.

Mary Roe's [indorsement](#) is not made effective by subsection (d), because the [securities](#) were not registered in the name of Mary Roe as representative. A purchaser or the [issuer](#) registering transfer should be required to determine whether Roe has power to act for John Doe. Purchasers and issuers can protect themselves in such cases by requiring signature guaranties. See Section [8-306](#).

6. Subsection (e) provides that the effectiveness of an [indorsement](#), [instruction](#), or [entitlement order](#) is determined as of the date it is made. The following example illustrates this subsection:

Example 4. [Certificated securities](#) are registered in the name of John Doe. John Doe dies and Mary Roe is appointed executor. Mary Roe indorses the [security certificate](#) that is registered in the name of John Doe and transfers it to a purchaser. After the [indorsement](#) and transfer, but before the security certificate is presented to the [issuer](#) for registration of transfer, Mary Roe is removed as executor and Martha Moe is appointed as her successor.

Mary Roe's [indorsement](#) is effective, because at the time Roe indorsed she was the [appropriate person](#) under subsection (a)(4). Her later removal as executor does not render the indorsement ineffective. Accordingly, the issuer would not be liable for registering the transfer. See Section [8-404](#).

Definitional Cross References

"Entitlement order" § [8-102\(a\)\(8\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Representative" § [1-201\(35\)](#)

"Securities account" § [8-501](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-108](#)

1. Subsections (a), (b), and (c) deal with warranties by security transferors to purchasers. Subsections (d) and (e) deal with warranties by security transferors to [issuers](#). Subsection (f) deals with presentment warranties.
2. Subsection (a) specifies the warranties made by a person who transfers a certificated security to a purchaser for value. Paragraphs (3), (4), and (5) make explicit several key points that are implicit in the general warranty of paragraph (6) that the transfer is [effective](#) and rightful. Subsection (b) sets forth the warranties made to a purchaser for value by one who originates an [instruction](#). These warranties are quite similar to those made by one transferring a certificated security, subsection (a), the principal difference being the absolute warranty of validity. If upon receipt of the instruction the [issuer](#) should dispute the validity of the security, the burden of proving validity is upon the transferor. Subsection (c) provides for the limited circumstances in which an [uncertificated security](#) could be transferred without an instruction, see Section [8-301\(b\)\(2\)](#). Subsections (d) and (e) give the issuer the benefit of the warranties of an indorser or originator on those matters not within the issuer's knowledge.
3. Subsection (f) limits the warranties made by a purchaser for value without notice whose presentation of a [security certificate](#) is defective in some way but to whom the [issuer](#) does register transfer. The effect is to deny the issuer a remedy against such a person unless at the time of presentment the person had knowledge of an unauthorized signature in a necessary [indorsement](#). The issuer can protect itself by refusing to make the transfer or, if it registers the transfer before it discovers the defect, by pursuing its remedy against a signature guarantor.
4. Subsection (g) eliminates all substantive warranties in the relatively unusual case of a [delivery](#) of certificated security by an agent of a disclosed principal where the agent delivers the exact certificate that it received from or for the principal. Subsection (h) limits the warranties given by a secured party who redelivers a certificate. Subsection (i) specifies the warranties of brokers in the more common scenarios.
5. Under Section [1-102\(3\)](#) the warranty provisions apply "unless otherwise agreed" and the parties may enter into express agreements to allocate the risks of possible defects. Usual estoppel principles apply with respect to transfers of both certificated and uncertificated securities whenever the purchaser has knowledge of the defect, and these warranties will not be breached in such a case.

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Appropriate person" § [8-107](#)

"Broker" § [8-102\(a\)\(3\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Person" § [1-201\(30\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Secured party" § [9-102\(a\)\(72\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-109](#)

1. Subsection (a) provides that a person who originates an [entitlement order](#) warrants to the [securities intermediary](#) that the order is authorized, and warrants the absence of adverse claims. Subsection (b) specifies the warranties that are given when a person who holds securities directly has the holding converted into indirect form. A person who delivers a certificate to a securities intermediary or originates an [instruction](#) for an [uncertificated security](#) gives to the securities intermediary the transfer warranties under Section [8-108](#). If the securities intermediary in turn delivers the certificate to a higher level securities intermediary, it gives the same warranties.

2. Subsection (c) states the warranties that a [securities intermediary](#) gives when a customer who has been holding securities in an account with the securities intermediary requests that certificates be delivered or that uncertificated securities be registered in the customer's name. The warranties are the same as those that brokers make with respect to securities that the brokers sell to or buy on behalf of the customers. See Section [8-108\(i\)](#).

3. As with the Section [8-108](#) warranties, the warranties specified in this section may be modified by agreement under Section [1-102\(3\)](#).

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Appropriate person" § [8-107](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Entitlement order" § [8-102\(a\)\(8\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Person" § [1-201\(30\)](#)

"Securities account" § [8-501](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-110](#)

1. This section deals with applicability and choice of law issues concerning Article 8. The distinction between the direct and indirect holding systems plays a significant role in determining the governing law. An investor in the direct holding system is registered on the books of the [issuer](#) and/or has possession of a [security certificate](#). Accordingly, the jurisdiction of incorporation of the issuer or location of the certificate determine the applicable law. By contrast, an investor in the indirect holding system has a [security entitlement](#), which is a bundle of rights against the [securities intermediary](#) with respect to a security, rather than a direct interest in the underlying security. Accordingly, in the rules for the indirect holding system, the jurisdiction of incorporation of the issuer of the underlying security or the location of any certificates that might be held by the intermediary or a higher tier intermediary, do not determine the applicable law.

The phrase "local law" refers to the law of a jurisdiction other than its conflict of laws rules. See Restatement (Second) of Conflict of Laws § 4.

2. Subsection (a) provides that the law of an [issuer's](#) jurisdiction governs certain issues where the substantive rules of Article 8 determine the issuer's rights and duties. Paragraph (1) of subsection (a) provides that the law of the issuer's jurisdiction governs the validity of the [security](#). This ensures that a single body of law will govern the questions addressed in Part 2 of Article 8, concerning the circumstances in which an issuer can and cannot assert invalidity as a defense against purchasers. Similarly, paragraphs (2), (3), and (4) of subsection (a) ensure that the issuer will be able to look to a single body of law on the questions addressed in Part 4 of Article 8, concerning the issuer's duties and liabilities with respect to registration of transfer.

Paragraph (5) of subsection (a) applies the law of an issuer's jurisdiction to the question whether an adverse claim can be asserted against a purchaser to whom transfer has been registered, or who has obtained control over an uncertificated security. Although this issue deals with the rights of persons other than the issuer, the law of the issuer's jurisdiction applies because the purchasers to whom the provision applies are those whose protection against adverse claims

depends on the fact that their interests have been recorded on the books of the issuer.

The principal policy reflected in the choice of law rules in subsection (a) is that an [issuer](#) and others should be able to look to a single body of law on the matters specified in subsection (a), rather than having to look to the law of all of the different jurisdictions in which security holders may reside. The choice of law policies reflected in this subsection do not require that the body of law governing all of the matters specified in subsection (a) be that of the jurisdiction in which the issuer is incorporated. Thus, subsection (d) provides that the term "issuer's jurisdiction" means the jurisdiction in which the issuer is organized, or, if permitted by that law, the law of another jurisdiction selected by the issuer. Subsection (d) also provides that issuers organized under the law of a State which adopts this Article may make such a selection, except as to the validity issue specified in paragraph (1). The question whether an issuer can assert the defense of invalidity may implicate significant policies of the issuer's jurisdiction of incorporation. See, e.g., Section [8-202](#) and Comments thereto.

Although subsection (a) provides that the issuer's rights and duties concerning registration of transfer are governed by the law of the issuer's jurisdiction, other matters related to registration of transfer, such as appointment of a guardian for a registered owner or the existence of agency relationships, might be governed by another jurisdiction's law. Neither this section nor Section [1-105](#) deals with what law governs the appointment of the administrator or executor; that question is determined under generally applicable choice of law rules.

3. Subsection (b) provides that the law of the securities intermediary's jurisdiction governs the issues concerning the indirect holding system that are dealt with in Article 8. Paragraphs (1) and (2) cover the matters dealt with in the Article 8 rules defining the concept of [security entitlement](#) and specifying the duties of securities intermediaries. Paragraph (3) provides that the law of the security intermediary's jurisdiction determines whether the intermediary owes any duties to an adverse claimant. Paragraph (4) provides that the law of the security intermediary's jurisdiction determines whether adverse claims can be asserted against [entitlement holders](#) and others.

Subsection (e) determines what is a "[securities intermediary's](#) jurisdiction." The policy of subsection (b) is to ensure that a securities intermediary and all of its [entitlement holders](#) can look to a single, readily-identifiable body of law to determine their rights and duties. Accordingly, subsection (e) sets out a sequential series of tests to facilitate identification of that body of law. Paragraph (1) of subsection (e) permits specification of the governing law by agreement. Because the policy of this section is to enable parties to determine, in advance and with certainty, what law will apply to transactions governed by this Article, the validation of selection of governing law by agreement is not conditioned upon a determination that the jurisdiction whose law is chosen bear a "reasonable relation" to the transaction. See Section [4A-507](#); compare Section [1-105\(1\)](#). That is also true with respect to the similar provisions in subsection (d) of this section and in Section [9-103\(6\)](#).

Subsection (f) makes explicit a point that is implicit in the Article 8 description of a [security entitlement](#) as a bundle of rights against the intermediary with respect

to a security or other [financial asset](#), rather than as a direct interest in the underlying security or other financial asset. The governing law for relationships in the indirect holding system is not determined by such matters as the jurisdiction of incorporation of the [issuer](#) of the securities held through the intermediary, or the location of any physical certificates held by the intermediary or a higher tier intermediary.

4. Subsection (c) provides a choice of law rule for adverse claim issues that may arise in connection with [delivery](#) of [security certificates](#) in the direct holding system. It applies the law of the place of delivery. If a certificated security issued by an Idaho corporation is sold, and the sale is settled by physical delivery of the certificate from Seller to Buyer in New York, under subsection (c), New York law determines whether Buyer takes free from adverse claims. The domicile of Seller, Buyer, and any adverse claimant is irrelevant.

5. The following examples illustrate how a court in a jurisdiction which has enacted this section would determine the governing law:

Example 1. John Doe, a resident of Kansas, maintains a [securities account](#) with Able & Co. Able is incorporated in Delaware. Its chief executive offices are located in Illinois. The office where Doe transacts business with Able is located in Missouri. The agreement between Doe and Able specifies that it is governed by Illinois law. Through the account, Doe holds [securities](#) of a Colorado corporation, which Able holds through Clearing Corporation. The rules of Clearing Corporation provide that the rights and duties of Clearing Corporation and its participants are governed by New York law. Subsection (a) specifies that a controversy concerning the rights and duties as between the issuer and Clearing Corporation is governed by Colorado law. Subsections (b) and (e) specify that a controversy concerning the rights and duties as between the Clearing Corporation and Able is governed by New York law, and that a controversy concerning the rights and duties as between Able and Doe is governed by Illinois law.

Example 2. Same facts as to Doe and Able as in Example 1. Through the account, Doe holds [securities](#) of a Senegalese corporation, which Able holds through Clearing Corporation. Clearing Corporation's operations are located in Belgium, and its rules and agreements with its participants provide that they are governed by Belgian law. Clearing Corporation holds the securities through a custodial account at the Paris branch office of Global Bank, which is organized under English law. The agreement between Clearing Corporation and Global Bank provides that it is governed by French law. Subsection (a) specifies that a controversy concerning the rights and duties as between the [issuer](#) and Global Bank is governed by Senegalese law. Subsections (b) and (e) specify that a controversy concerning the rights and duties as between Global Bank and Clearing Corporation is governed by French law, that a controversy concerning the rights and duties as between Clearing Corporation and Able is governed by Belgian law, and that a controversy concerning the rights and duties as between Able and Doe is governed by Illinois law.

6. To the extent that this section does not specify the governing law, general choice of law rules apply. For example, suppose that in either of the examples in the preceding Comment, Doe enters into an agreement with Roe, also a resident of Kansas, in which Doe agrees to transfer all of his interests in the securities

held through Able to Roe. Article 8 does not deal with whether such an agreement is enforceable or whether it gives Roe some interest in Doe's [security entitlement](#). This section specifies what jurisdiction's law governs the issues that are dealt with in Article 8. Article 8, however, does specify that securities intermediaries have only limited duties with respect to adverse claims. See Section [8-115](#). Subsection (b)(3) of this section provides that Illinois law governs whether Able owes any duties to an adverse claimant. Thus, if Illinois has adopted Revised Article 8, Section [8-115](#) as enacted in Illinois determines whether Roe has any rights against Able.

7. The choice of law provisions concerning security interests in securities and security entitlements are set out in Section [9-103\(6\)](#).

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Agreement" § [1-201\(3\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Issuer" § [8-201](#)

"Person" § [1-201\(30\)](#)

"Purchase" § [1-201\(32\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-111](#)

1. The experience of the past few decades shows that securities holding and settlement practices may develop rapidly, and in unforeseeable directions. Accordingly, it is desirable that the rules of Article 8 be adaptable both to ensure that commercial law can conform to changing practices and to ensure that commercial law does not operate as an obstacle to developments in [securities](#) practice. Even if practices were unchanging, it would not be possible in a general

statute to specify in detail the rules needed to provide certainty in the operations of the clearance and settlement system.

The provisions of this Article and Article 1 on the effect of agreements provide considerable flexibility in the specification of the details of the rights and obligations of participants in the securities holding system by agreement. See Sections [8-504 through 8-509](#), and Section [1-102\(3\)](#) and [\(4\)](#). Given the magnitude of the exposures involved in securities transactions, however, it may not be possible for the parties in developing practices to rely solely on private agreements, particularly with respect to matters that might affect others, such as creditors. For example, in order to be fully [effective](#), rules of clearing corporations on the finality or reversibility of securities settlements must not only bind the participants in the [clearing corporation](#) but also be effective against their creditors. Section [8-111](#) provides that clearing corporation rules are effective even if they indirectly affect third parties, such as creditors of a participant. This provision does not, however, permit rules to be adopted that would govern the rights and obligations of third parties other than as a consequence of rules that specify the rights and obligations of the clearing corporation and its participants.

2. The definition of [clearing corporation](#) in Section [8-102](#) covers only federal reserve banks, entities registered as clearing agencies under the federal securities laws, and others subject to comparable regulation. The rules of registered clearing agencies are subject to regulatory oversight under the federal securities laws.

Definitional Cross References

"Clearing corporation" § [8-102\(a\)\(5\)](#)

Official Comment [§ 8-112](#)

1. In dealing with [certificated securities](#) the instrument itself is the vital thing, and therefore a valid levy cannot be made unless all possibility of the certificate's wrongfully finding its way into a transferee's hands has been removed. This can be accomplished only when the certificate is in the possession of a public officer, the [issuer](#), or an independent third party. A debtor who has been enjoined can still transfer the security in contempt of court. See *Overlock v. Jerome-Portland Copper Mining Co.*, 29 Ariz. 560, 243 P. 400 (1926). Therefore, although injunctive relief is provided in subsection (e) so that creditors may use this method to gain control of the certificated security, the [security certificate](#) itself must be reached to constitute a proper levy whenever the debtor has possession.

2. Subsection (b) provides that when the [security](#) is uncertificated and registered in the debtor's name, the debtor's interest can be reached only by legal process upon the issuer. The most logical place to serve the issuer would be the place where the transfer records are maintained, but that location might be difficult to identify, especially when the separate elements of a computer network might be situated in different places. The chief executive office is selected as the appropriate place by analogy to Section [9-307\(b\)\(3\)](#). See Comment 2 to that section. This section indicates only how attachment is to be made, not when it is

legally justified. For that reason there is no conflict between this section and *Shaffer v. Heitner*, 433 U.S. 186 (1977).

3. Subsection (c) provides that a [security entitlement](#) can be reached only by legal process upon the debtor's security intermediary. Process is [effective](#) only if directed to the debtor's own security intermediary. If Debtor holds securities through [Broker](#), and Broker in turn holds through Clearing Corporation, Debtor's property interest is a security entitlement against Broker. Accordingly, Debtor's creditor cannot reach Debtor's interest by legal process directed to the Clearing Corporation. See also Section [8-115](#).

4. Subsection (d) provides that when a certificated security, an uncertificated security, or a security entitlement is controlled by a secured party, the debtor's interest can be reached by legal process upon the secured party. This section does not attempt to provide for rights as between the creditor and the secured party, as, for example, whether or when the secured party must liquidate the security.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Issuer" § [8-201](#)

"Secured party" § [9-102\(a\)\(72\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-113](#)

This section provides that the statute of frauds does not apply to contracts for the sale of [securities](#), reversing prior law which had a special statute of frauds in Section 8-319 (1978). With the increasing use of electronic means of communication, the statute of frauds is unsuited to the realities of the securities business. For securities transactions, whatever benefits a statute of frauds may play in filtering out fraudulent claims are outweighed by the obstacles it places in the development of modern commercial practices in the securities business.

Definitional Cross References

"Action" § [1-201\(1\)](#)

"Contract" § [1-201\(11\)](#)

"Writing" § [1-201\(46\)](#)

Official Comment § [8-114](#)

This section adapts the rules of negotiable instruments law concerning procedure in actions on instruments, see Section [3-308](#), to actions on [certificated securities](#) governed by this Article. An "action on a security" includes any action or proceeding brought against the [issuer](#) to enforce a right or interest that is part of the security, such as an action to collect principal or interest or a dividend, or to establish a right to vote or to receive a new security under an exchange offer or plan of reorganization. This section applies only to certificated securities; actions on [uncertificated securities](#) are governed by general evidentiary principles.

Definitional Cross References

"Action" § [1-201\(1\)](#)

"Burden of establishing" § [1-201\(8\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Issuer" § [8-201](#)

"Presumed" § [1-201\(31\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment § [8-115](#)

1. Other provisions of Article 8 protect certain purchasers against adverse claims, both for the direct holding system and the indirect holding system. See Sections [8-303](#) and [8-502](#). This section deals with the related question of the possible liability of a person who acted as the "conduit" for a securities transaction. It covers both securities intermediaries -- the "conduits" in the indirect holding system -- and brokers or other agents or bailees -- the "conduits" in the direct holding system. The following examples illustrate its operation:

Example 1. John Doe is a customer of the brokerage firm of Able & Co. Doe delivers to Able a certificate for 100 shares of XYZ Co. common stock, registered in Doe's name and properly indorsed, and asks the firm to sell it for him. Able does so. Later, John Doe's spouse Mary Doe brings an action against Able asserting that Able's action was wrongful against her because the XYZ Co. stock was marital property in which she had an interest, and John Doe was acting wrongfully against her in transferring the [securities](#).

Example 2. Mary Roe is a customer of the brokerage firm of Baker & Co. and holds her securities through a [securities account](#) with Baker. Roe instructs Baker to sell 100 shares of XYZ Co. common stock that she carried in her account. Baker does so. Later, Mary Roe's spouse John Roe brings an action against Baker asserting that Baker's action was wrongful against him because the XYZ Co. stock was marital property in which he had an interest, and Mary Roe was acting wrongfully against him in transferring the securities.

Under common law conversion principles, Mary Doe might be able to assert that Able & Co. is liable to her in Example 1 for exercising dominion over property inconsistent with her rights in it. On that or some similar theory John Roe might assert that Baker is liable to him in Example 2. Section 8-115 protects both Able and Baker from liability.

2. The policy of this section is similar to that of many other rules of law that protect agents and bailees from liability as innocent converters. If a thief steals property and ships it by mail, express service, or carrier, to another person, the recipient of the property does not obtain good title, even though the recipient may have given value to the thief and had no notice or knowledge that the property was stolen. Accordingly, the true owner can recover the property from the recipient or obtain damages in a conversion or similar action. An action against the postal service, express company, or carrier presents entirely different policy considerations. Accordingly, general tort law protects agents or bailees who act on the [instructions](#) of their principals or bailors. See Restatement (Second) of Torts § 235. See also UCC Section [7-404](#).

3. Except as provided in paragraph 3, this section applies even though the [securities intermediary](#), or the [broker](#) or other agent or bailee, had notice or knowledge that another person asserts a claim to the securities. Consider the following examples:

Example 3. Same facts as in Example 1, except that before John Doe brought the XYZ Co. [security certificate](#) to Able for sale, Mary Doe telephoned or wrote to the firm asserting that she had an interest in all of John Doe's securities and demanding that they not trade for him.

Example 4. Same facts as in Example 2, except that before Mary Roe gave an [entitlement order](#) to Baker to sell the XYZ Co. [securities](#) from her account, John Roe telephoned or wrote to the firm asserting that he had an interest in all of Mary Roe's securities and demanding that they not trade for her.

Section 8-115 protects Able and Baker from liability. The protections of Section 8-115 do not depend on the presence or absence of [notice of adverse claims](#). It is essential to the securities settlement system that brokers and securities intermediaries be able to act promptly on the directions of their customers. Even though a firm has notice that someone asserts a claim to a customer's securities or security entitlements, the firm should not be placed in the position of having to make a legal judgment about the validity of the claim at the risk of liability either to its customer or to the third party for guessing wrong. Under this section, the [broker](#) or [securities intermediary](#) is privileged to act on the [instructions](#) of its customer or [entitlement holder](#), unless it has been served with a restraining order or other legal process enjoining it from doing so. This is already the law in

many jurisdictions. For example a section of the New York Banking Law provides that banks need not recognize any adverse claim to funds or securities on deposit with them unless they have been served with legal process. N.Y. Banking Law § 134. Other sections of the UCC embody a similar policy. See Sections [3-602](#), [5-114\(2\)\(b\)](#).

Paragraph (1) of this section refers only to a court order enjoining the securities intermediary or the [broker](#) or other agent or bailee from acting at the [instructions](#) of the customer. It does not apply to cases where the adverse claimant tells the intermediary or broker that the customer has been enjoined, or shows the intermediary or broker a copy of a court order binding the customer.

Paragraph (3) takes a different approach in one limited class of cases, those where a customer sells stolen [certificated securities](#) through a securities firm. Here the policies that lead to protection of securities firms against assertions of other sorts of claims must be weighed against the desirability of having securities firms guard against the disposition of stolen securities. Accordingly, paragraph (3) denies protection to a [broker](#), custodian, or other agent or bailee who receives a stolen [security certificate](#) from its customer, if the broker, custodian, or other agent or bailee had notice of adverse claims. The circumstances that give notice of adverse claims are specified in Section [8-105](#). The result is that brokers, custodians, and other agents and bailees face the same liability for selling stolen certificated securities that purchasers face for buying them.

4. As applied to securities intermediaries, this section embodies one of the fundamental principles of the Article 8 indirect holding system rules -- that a [securities intermediary](#) owes duties only to its own [entitlement holders](#). The following examples illustrate the operation of this section in the multi-tiered indirect holding system:

Example 5. Able & Co., a broker-dealer, holds 50,000 shares of XYZ Co. stock in its account at Clearing Corporation. Able acquired the XYZ shares from another firm, Baker & Co., in a transaction that Baker contends was tainted by fraud, giving Baker a right to rescind the transaction and recover the XYZ shares from Able. Baker sends notice to Clearing Corporation stating that Baker has a claim to the 50,000 shares of XYZ Co. in Able's account. Able then initiates an [entitlement order](#) directing Clearing Corporation to transfer the 50,000 shares of XYZ Co. to another firm in settlement of a trade. Under Section 8-115, Clearing Corporation is privileged to comply with Able's entitlement order, without fear of liability to Baker. This is so even though Clearing Corporation has notice of Baker's claim, unless Baker obtains a court order enjoining Clearing Corporation from acting on Able's entitlement order.

Example 6. Able & Co., a broker-dealer, holds 50,000 shares of XYZ Co. stock in its account at Clearing Corporation. Able initiates an [entitlement order](#) directing Clearing Corporation to transfer the 50,000 shares of XYZ Co. to another firm in settlement of a trade. That trade was made by Able for its own account, and the proceeds were devoted to its own use. Able becomes insolvent, and it is discovered that Able has a shortfall in the shares of XYZ Co. stock that it should have been carrying for its customers. Able's customers bring an action against Clearing Corporation asserting that Clearing Corporation acted wrongfully in transferring the XYZ shares on Able's order because those were shares that

should have been held by Able for its customers. Under Section 8-115, Clearing Corporation is not liable to Able's customers, because Clearing Corporation acted on an [effective](#) entitlement order of its own [entitlement holder](#), Able. Clearing Corporation's protection against liability does not depend on the presence or absence of notice or knowledge of the claim by Clearing Corporation.

5. If the conduct of a [securities intermediary](#) or a [broker](#) or other agent or bailee rises to a level of complicity in the wrongdoing of its customer or principal, the policies that favor protection against liability do not apply. Accordingly, paragraph (2) provides that the protections of this section do not apply if the securities intermediary or broker or other agent or bailee acted in collusion with the customer or principal in violating the rights of another person. The collusion test is intended to adopt a standard akin to the tort rules that determine whether a person is liable as an aider or abettor for the tortious conduct of a third party. See Restatement (Second) of Torts § 876.

Knowledge that the action of the customer is wrongful is a necessary but not sufficient condition of the collusion test. The aspect of the role of securities intermediaries and brokers that Article 8 deals with is the clerical or ministerial role of implementing and recording the securities transactions that their customers conduct. Faithful performance of this role consists of following the [instructions](#) of the customer. It is not the role of the record-keeper to police whether the transactions recorded are appropriate, so mere awareness that the customer may be acting wrongfully does not itself constitute collusion. That, of course, does not insulate an intermediary or [broker](#) from responsibility in egregious cases where its action goes beyond the ordinary standards of the business of implementing and recording transactions, and reaches a level of affirmative misconduct in assisting the customer in the commission of a wrong.

Definitional Cross References

"Broker" § [8-102\(a\)\(3\)](#)

"Effective" § [8-107](#)

"Entitlement order" § [8-102\(a\)\(8\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-116](#)

1. This section is intended to make explicit two points that, while implicit in other provisions, are of sufficient importance to the operation of the indirect holding system that they warrant explicit statement. First, it makes clear that a [securities intermediary](#) that receives a [financial asset](#) and establishes a [security entitlement](#) in respect thereof in favor of an [entitlement holder](#) is a "purchaser" of the financial asset that the securities intermediary received. Second, it makes

clear that by establishing a security entitlement in favor of an entitlement holder a securities intermediary gives value for any corresponding financial asset that the securities intermediary receives or acquires from another party, whether the intermediary holds directly or indirectly.

In many cases a securities intermediary that receives a [financial asset](#) will also be transferring value to the person from whom the financial asset was received. That, however, is not always the case. Payment may occur through a different system than settlement of the securities side of the transaction, or the securities might be transferred without a corresponding payment, as when a person moves an account from one securities intermediary to another. Even though the securities intermediary does not give value to the transferor, it does give value by incurring obligations to its own [entitlement holder](#). Although the general definition of value in Section [1-201\(44\)\(d\)](#) should be interpreted to cover the point, this section is included to make this point explicit.

2. The following examples illustrate the effect of this section:

Example 1. Buyer buys 1000 shares of XYZ Co. common stock through Buyer's [broker](#) Able & Co. to be held in Buyer's [securities account](#). In settlement of the trade, the selling broker delivers to Able a [security certificate](#) in street name, indorsed in blank, for 1000 shares XYZ Co. stock, which Able holds in its vault. Able credits Buyer's account for securities in that amount. Section 8-116 specifies that Able is a purchaser of the XYZ Co. stock certificate, and gave value for it. Thus, Able can obtain the benefit of Section [8-303](#), which protects purchasers for value, if it satisfies the other requirements of that section.

Example 2. Buyer buys 1000 shares XYZ Co. common stock through Buyer's [broker](#) Able & Co. to be held in Buyer's [securities account](#). The trade is settled by crediting 1000 shares XYZ Co. stock to Able's account at Clearing Corporation. Able credits Buyer's account for securities in that amount. When Clearing Corporation credits Able's account, Able acquires a [security entitlement](#) under Section [8-501](#). Section [8-116](#) specifies that Able acquired this security entitlement for value. Thus, Able can obtain the benefit of Section [8-502](#), which protects persons who acquire security entitlements for value, if it satisfies the other requirements of that section.

Example 3. Thief steals a certificated bearer bond from Owner. Thief sends the certificate to his [broker](#) Able & Co. to be held in his [securities account](#), and Able credits Thief's account for the bond. Section 8-116 specifies that Able is a purchaser of the bond and gave value for it. Thus, Able can obtain the benefit of Section [8-303](#), which protects purchasers for value, if it satisfies the other requirements of that section.

Definitional Cross References

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

Official Comment § [8-201](#)

1. The definition of "[issuer](#)" in this section functions primarily to describe the persons whose defenses may be cut off under the rules in Part 2. In large measure it simply tracks the language of the definition of [security](#) in Section [8-102\(a\)\(15\)](#).

2. Subsection (b) distinguishes the obligations of a guarantor as [issuer](#) from those of the principal obligor. However, it does not exempt the guarantor from the impact of subsection (d) of Section [8-202](#). Whether or not the obligation of the guarantor is noted on the security is immaterial. Typically, guarantors are parent corporations, or stand in some similar relationship to the principal obligor. If that relationship existed at the time the security was originally issued the guaranty would probably have been noted on the security. However, if the relationship arose afterward, e.g., through a purchase of stock or properties, or through merger or consolidation, probably the notation would not have been made. Nonetheless, the holder of the security is entitled to the benefit of the obligation of the guarantor.

3. Subsection (c) narrows the definition of "[issuer](#)" for purposes of Part 4 of this Article (registration of transfer). It is supplemented by Section [8-407](#).

Definitional Cross References

"Person" § [1-201\(30\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment § [8-202](#)

1. In this Article the rights of the purchaser for value without notice are divided into two aspects, those against the [issuer](#), and those against other claimants to the [security](#). Part 2 of this Article, and especially this section, deal with rights against the issuer.

Subsection (a) states, in accordance with the prevailing case law, the right of the issuer (who prepares the text of the security) to include terms incorporated by adequate reference to an extrinsic source, so long as the terms so incorporated do not conflict with the stated terms. Thus, the standard practice of referring in a bond or debenture to the trust indenture under which it is issued without spelling out its necessarily complex and lengthy provisions is approved. Every stock certificate refers in some manner to the charter or articles of incorporation of the issuer. At least where there is more than one class of stock authorized applicable corporation codes specifically require a statement or summary as to

preferences, voting powers and the like. References to constitutions, statutes, ordinances, rules, regulations or orders are not so common, except in the obligations of governments or governmental agencies or units; but where appropriate they fit into the rule here stated.

Courts have generally held that an issuer is estopped from denying representations made in the text of a [security](#). *Delaware-New Jersey Ferry Co. v. Leeds*, 21 Del.Ch. 279, 186 A. 913 (1936). Nor is a defect in form or the invalidity of a security normally available to the issuer as a defense. *Bonini v. Family Theatre Corporation*, 327 Pa. 273, 194 A. 498 (1937); *First National Bank of Fairbanks v. Alaska Airmotive*, 119 F.2d 267 (C.C.A.Alaska 1941).

2. The rule in subsection (a) requiring that the terms of a security be noted or referred to on the certificate is based on practices and expectations in the direct holding system for [certificated securities](#). This rule does not express a general rule or policy that the terms of a security are [effective](#) only if they are [communicated](#) to beneficial owners in some particular fashion. Rather, subsection (a) is based on the principle that a purchaser who does obtain a certificate is entitled to assume that the terms of the security have been noted or referred to on the certificate. That policy does not come into play in a securities holding system in which purchasers do not take [delivery](#) of certificates.

The provisions of subsection (a) concerning notation of terms on [security certificates](#) are necessary only because paper certificates play such an important role for [certificated securities](#) that a purchaser should be protected against assertion of any defenses or rights that are not noted on the certificate. No similar problem exists with respect to [uncertificated securities](#). The last sentence of subsection (a) is, strictly speaking, unnecessary, since it only recognizes the fact that the terms of an uncertificated security are determined by whatever other law or agreement governs the security. It is included only to preclude any inference that uncertificated securities are subject to any requirement analogous to the requirement of notation of terms on security certificates.

The rule of subsection (a) applies to the indirect holding system only in the sense that if a certificated security has been delivered to the [clearing corporation](#) or other [securities intermediary](#), the terms of the security should be noted or referred to on the certificate. If the security is uncertificated, that principle does not apply even at the [issuer](#)-clearing corporation level. The beneficial owners who hold securities through the clearing corporation are bound by the terms of the security, even though they do not actually see the certificate. Since [entitlement holders](#) in an indirect holding system have not taken [delivery](#) of certificates, the policy of subsection (a) does not apply.

3. The penultimate sentence of subsection (a) and all of subsection (b) embody the concept that it is the duty of the [issuer](#), not of the purchaser, to make sure that the [security](#) complies with the law governing its issue. The penultimate sentence of subsection (a) makes clear that the issuer cannot, by incorporating a reference to a statute or other document, charge the purchaser with notice of the security's invalidity. Subsection (b) gives to a purchaser for value without notice of the defect the right to enforce the security against the issuer despite the presence of a defect that otherwise would render the security invalid. There are three circumstances in which a purchaser does not gain such rights: first, if the

defect involves a violation of constitutional provisions, these rights accrue only to a subsequent purchaser, that is, one who takes other than by original issue. This Article leaves to the law of each particular State the rights of a purchaser on original issue of a security with a constitutional defect. No negative implication is intended by the explicit grant of rights to a subsequent purchaser.

Second, governmental issuers are distinguished in subsection (b) from other issuers as a matter of public policy, and additional safeguards are imposed before governmental issues are validated. Governmental issuers are estopped from asserting defenses only if there has been substantial compliance with the legal requirements governing the issue or if substantial consideration has been received and a stated purpose of the issue is one for which the issuer has power to borrow money or issue the [security](#). The purpose of the substantial compliance requirement is to make certain that a mere technicality as, e.g., in the manner of publishing election notices, shall not be a ground for depriving an innocent purchaser of rights in the security. The policy is here adopted of such cases as *Tommie v. City of Gadsden*, 229 Ala. 521, 158 So. 763 (1935), in which minor discrepancies in the form of the election ballot used were overlooked and the bonds were declared valid since there had been substantial compliance with the statute.

A long and well established line of federal cases recognizes the principle of estoppel in favor of purchasers for value without notices where municipalities issue bonds containing recitals of compliance with governing constitutional and statutory provisions, made by the municipal authorities entrusted with determining such compliance. *Chaffee County v. Potter*, 142 U.S. 355 (1892); *Oregon v. Jennings*, 119 U.S. 74 (1886); *Gunnison County Commissioners v. Rollins*, 173 U.S. 255 (1898). This rule has been qualified, however, by requiring that the municipality have power to issue the [security](#). *Anthony v. County of Jasper*, 101 U.S. 693 (1879); *Town of South Ottawa v. Perkins*, 94 U.S. 260 (1876). This section follows the case law trend, simplifying the rule by setting up two conditions for an estoppel against a governmental [issuer](#): (1) substantial consideration given, and (2) power in the issuer to borrow money or issue the security for the stated purpose. As a practical matter the problem of policing governmental issuers has been alleviated by the present practice of requiring legal opinions as to the validity of the issue. The bulk of the case law on this point is nearly 100 years old and it may be assumed that the question now seldom arises.

Section [8-210](#), regarding [overissue](#), provides the third exception to the rule that an innocent purchase for value takes a valid security despite the presence of a defect that would otherwise give rise to invalidity. See that section and its Comment for further explanation.

4. Subsection (e) is included to make clear that this section does not affect the presently recognized right of either party to a "when, as and if" or "when distributed" contract to cancel the contract on substantial change.

5. Subsection (f) has been added because the introduction of the [security entitlement](#) concept requires some adaptation of the Part 2 rules, particularly those that distinguish between purchasers who take by original issue and subsequent purchasers. The basic concept of Part 2 is to apply to investment

securities the principle of negotiable instruments law that an obligor is precluded from asserting most defenses against purchasers for value without notice. Section [8-202](#) describes in some detail which defenses [issuers](#) can raise against purchasers for value and subsequent purchasers for value. Because these rules were drafted with the direct holding system in mind, some interpretive problems might be presented in applying them to the indirect holding. For example, if a municipality issues a bond in book-entry only form, the only direct "purchaser" of that bond would be the [clearing corporation](#). The policy of precluding the issuer from asserting defenses is, however, equally applicable. Subsection (f) is designed to ensure that the defense preclusion rules developed for the direct holding system will also apply to the indirect holding system.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Notice" § [1-201\(25\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-203](#)

1. The problem of matured or called securities is here dealt with in terms of the effect of such events in giving notice of the [issuer's](#) defenses and not in terms of "negotiability". The substance of this section applies only to [certificated securities](#) because certificates may be transferred to a purchaser by [delivery](#) after the security has matured, been called, or become redeemable or exchangeable. It is contemplated that [uncertificated securities](#) which have matured or been called will merely be canceled on the books of the issuer and the proceeds sent to the registered owner. Uncertificated securities which have become redeemable or exchangeable, at the option of the owner, may be transferred to a purchaser, but the transfer is effectuated only by registration of transfer, thus necessitating communication with the issuer. If defects or defenses in such securities exist, the issuer will necessarily have the opportunity to bring them to the attention of the purchaser.

2. The fact that a [security certificate](#) is in circulation long after it has been called for redemption or exchange must give rise to the question in a purchaser's mind as to why it has not been surrendered. After the lapse of a reasonable period of time a purchaser can no longer claim "no reason to know" of any defects or irregularities in its issue. Where funds are available for the redemption the security certificate is normally turned in more promptly and a shorter time is set as the "reasonable period" than is set where funds are not available.

Defaulted [certificated securities](#) may be traded on financial markets in the same manner as unmatured and defaulted instruments and a purchaser might not be placed upon notice of irregularity by the mere fact of default. An [issuer](#), however, should at some point be placed in a position to determine definitely its liability on an invalid or improper issue, and for this purpose a security under this section becomes "stale" two years after the default. A different rule applies when the question is notice not of issuer's defenses but of claims of ownership. Section 8-105 and Comment.

3. Nothing in this section is designed to extend the life of preferred stocks called for redemption as "shares of stock" beyond the redemption date. After such a call, the security represents only a right to the funds set aside for redemption.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Notice" § [1-201\(25\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-204](#)

1. Restrictions on transfer of securities are imposed by [issuers](#) in a variety of circumstances and for a variety of purposes, such as to retain control of a close corporation or to ensure compliance with federal securities laws. Other law determines whether such restrictions are permissible. This section deals only with the consequences of failure to note the restriction on a [security certificate](#).

This section imposes no bar to enforcement of a restriction on transfer against a person who has actual knowledge of it.

2. A restriction on transfer of a certificated security is ineffective against a person without knowledge of the restriction unless the restriction is noted conspicuously on the certificate. The word "noted" is used to make clear that the restriction need not be set forth in full text. Refusal by an issuer to register a transfer on the basis of an unnoted restriction would be a violation of the issuer's duty to register under Section [8-401](#).

3. The policy of this section is the same as in Section [8-202](#). A purchaser who takes [delivery](#) of a certificated security is entitled to rely on the terms stated on the certificate. That policy obviously does not apply to [uncertificated securities](#). For uncertificated securities, this section requires only that the registered owner has been notified of the restriction. Suppose, for example, that A is the

registered owner of an uncertificated security, and that the [issuer](#) has notified A of a restriction on transfer. A agrees to sell the security to B, in violation of the restriction. A completes a written [instruction](#) directing the issuer to register transfer to B, and B pays A for the security at the time A delivers the instruction to B. A does not inform B of the restriction, and B does not otherwise have notice or knowledge of it at the time B pays and receives the instruction. B presents the instruction to the issuer, but the issuer refuses to register the transfer on the grounds that it would violate the restriction. The issuer has complied with this section, because it did notify the registered owner A of the restriction. The issuer's refusal to register transfer is not wrongful. B has an action against A for breach of transfer warranty, see Section [8-108\(b\)\(4\)\(iii\)](#). B's mistake was treating an uncertificated security transaction in the fashion appropriate only for a certificated security. The mechanism for transfer of uncertificated securities is registration of transfer on the books of the issuer; handing over an instruction only initiates the process. The purchaser should make arrangements to ensure that the price is not paid until it knows that the issuer has or will register transfer.

4. In the indirect holding system, investors neither take physical [delivery](#) of [security certificates](#) nor have uncertificated securities registered in their names. So long as the requirements of this section have been satisfied at the level of the relationship between the [issuer](#) and the [securities intermediary](#) that is a direct holder, this section does not preclude the issuer from enforcing a restriction on transfer. See Section [8-202\(a\)](#) and Comment 2 thereto.

5. This section deals only with restrictions imposed by the [issuer](#). Restrictions imposed by statute are not affected. See *Quiner v. Marblehead Social Co.*, 10 Mass. 476 (1813); *Madison Bank v. Price*, 79 Kan. 289, 100 P. 280 (1909); *Healey v. Steele Center Creamery Ass'n*, 115 Minn. 451, 133 N.W. 69 (1911). Nor does it deal with private agreements between stockholders containing restrictive covenants as to the sale of the security.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Conspicuous" § [1-201\(10\)](#)

"Issuer" § [8-201](#)

"Knowledge" § [1-201\(25\)](#)

"Notify" § [1-201\(25\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-205](#)

1. The problem of forged or unauthorized signatures may arise where an employee of the [issuer](#), transfer agent, or registrar has access to [securities](#) which the employee is required to prepare for issue by affixing the corporate seal or by adding a signature necessary for issue. This section is based upon the issuer's duty to avoid the negligent entrusting of securities to such persons. Issuers have long been held responsible for signatures placed upon securities by parties whom they have held out to the public as authorized to prepare such securities. See *Fifth Avenue Bank of New York v. The Forty-Second & Grand Street Ferry Railroad Co.*, 137 N.Y. 231, 33 N.E. 378, 19 L.R.A. 331, 33 Am.St.Rep. 712 (1893); *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68, 31 L.R.A. 776, 51 Am.St.Rep. 727 (1896). The "apparent authority" concept of some of the case-law, however, is here extended and this section expressly rejects the technical distinction, made by courts reluctant to recognize forged signatures, between cases where forgers sign signatures they are authorized to sign under proper circumstances and those in which they sign signatures they are never authorized to sign. *Citizens' & Southern National Bank v. Trust Co. of Georgia*, 50 Ga.App. 681, 179 S.E. 278 (1935). Normally the purchaser is not in a position to determine which signature a forger, entrusted with the preparation of securities, has "apparent authority" to sign. The issuer, on the other hand, can protect itself against such fraud by the careful selection and bonding of agents and employees, or by action over against transfer agents and registrars who in turn may bond their personnel.

2. The [issuer](#) cannot be held liable for the honesty of employees not entrusted, directly or indirectly, with the signing, preparation, or responsible handling of similar [securities](#) and whose possible commission of forgery it has no reason to anticipate. The result in such cases as *Hudson Trust Co. v. American Linseed Co.*, 232 N.Y. 350, 134 N.E. 178 (1922), and *Dollar Savings Fund & Trust Co. v. Pittsburgh Plate Glass Co.*, 213 Pa. 307, 62 A. 916, 5 Ann.Cas. 248 (1906) is here adopted.

3. This section is not concerned with forged or unauthorized indorsements, but only with unauthorized signatures of issuers, transfer agents, etc., placed upon [security certificates](#) during the course of their issue. The protection here stated is available to all purchasers for value without notice and not merely to subsequent purchasers.

Definitional Cross References

"Certificated security" [§ 8-102\(a\)\(4\)](#)

"Issuer" [§ 8-201](#)

"Notice" [§ 1-201\(25\)](#)

"Purchaser" [§ 1-201\(33\)](#) & [8-116](#)

"Security certificate" [§ 8-102\(a\)\(14\)](#)

"Unauthorized signature"§ [1-201\(43\)](#)

Official Comment [§ 8-206](#)

1. The problem of forged or unauthorized signatures necessary for the issue or transfer of a [security](#) is not involved here, and a person in possession of a blank certificate is not, by this section, given authority to fill in blanks with such signatures. Completion of blanks left in a transfer [instruction](#) is dealt with elsewhere (Section [8-305\(a\)](#)).
2. Blanks left upon issue of a [security certificate](#) are the only ones dealt with here, and a purchaser for value without notice is protected. A purchaser is not in a good position to determine whether blanks were completed by the [issuer](#) or by some person not authorized to complete them. On the other hand the issuer can protect itself by not placing its signature on the writing until the blanks are completed or, if it does sign before all blanks are completed, by carefully selecting the agents and employees to whom it entrusts the writing after authentication. With respect to a security certificate that is completed by the issuer but later is altered, the issuer has done everything it can to protect the purchaser and thus is not charged with the terms as altered. However, it is charged according to the original terms, since it is not thereby prejudiced. If the completion or alteration is obviously irregular, the purchaser may not qualify as a purchaser who took without notice under this section.
3. Only the purchaser who physically takes the certificate is directly protected. However, a transferee may receive protection indirectly through Section [8-302\(a\)](#).
4. The protection granted a purchaser for value without notice under this section is modified to the extent that an [overissue](#) may result where an incorrect amount is inserted into a blank (Section [8-210](#)).

Definitional Cross References

"Notice" § [1-201\(25\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Unauthorized signature"§ [1-201\(43\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-207](#)

1. Subsection (a) states the [issuer's](#) right to treat the registered owner of a [security](#) as the person entitled to exercise all the rights of an owner. This right of the issuer is limited by the provisions of Part 4 of this article. Once there has been due presentation for registration of transfer, the issuer has a duty to

register ownership in the name of the transferee. Section [8-401](#). Thus its right to treat the old registered owner as exclusively entitled to the rights of ownership must cease.

The issuer may under this section make distributions of money or securities to the registered owners of securities without requiring further proof of ownership, provided that such distributions are distributable to the owners of all securities of the same issue and the terms of the security do not require surrender of a [security certificate](#) as a condition of payment or exchange. Any such distribution shall constitute a defense against a claim for the same distribution by a person, even if that person is in possession of the security certificate and is a [protected purchaser](#) of the security. See PEB Commentary No. 4, dated March 10, 1990.

2. Subsection (a) is permissive and does not require that the issuer deal exclusively with the registered owner. It is free to require proof of ownership before paying out dividends or the like if it chooses to. *Barbato v. Breeze Corporation*, 128 N.J.L. 309, 26 A.2d 53 (1942).
3. This section does not operate to determine who is finally entitled to exercise voting and other rights or to receive payments and distributions. The parties are still free to incorporate their own arrangements as to these matters in seller-purchaser agreements which may be definitive as between them.
4. No change in existing state laws as to the liability of registered owners for calls and assessments is here intended; nor is anything in this section designed to estop record holders from denying ownership when assessments are levied if they are otherwise entitled to do so under state law. See *State ex rel. Squire v. Murfey, Blosson & Co.*, 131 Ohio St. 289, 2 N.E.2d 866 (1936); *Willing v. Delaplaine*, 23 F.Supp. 579 (1937).
5. No interference is intended with the common practice of closing the transfer books or taking a record date for dividend, voting, and other purposes, as provided for in by-laws, charters, and statutes.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-208](#)

1. The warranties here stated express the current understanding and prevailing case law as to the effect of the signatures of authenticating trustees, transfer agents, and registrars. See *Jarvis v. Manhattan Beach Co.*, 148 N.Y. 652, 43 N.E. 68, 31 L.R.A. 776, 51 Am.St.Rep. 727 (1896). Although it has generally been regarded as the particular obligation of the transfer agent to determine whether [securities](#) are in proper form as provided by the by-laws and Articles of Incorporation, neither a registrar nor an authenticating trustee should properly place a signature upon a certificate without determining whether it is at least regular on its face. The obligations of these parties in this respect have therefore been made explicit in terms of due care. See *Feldmeier v. Mortgage Securities, Inc.*, 34 Cal.App.2d 201, 93 P.2d 593 (1939).

2. Those cases which hold that an authenticating trustee is not liable for any defect in the mortgage or property which secures the bond or for any fraudulent misrepresentations made by the [issuer](#) are not here affected since these matters do not involve the genuineness or proper form of the security. *Ainsa v. Mercantile Trust Co.*, 174 Cal. 504, 163 P. 898 (1917); *Tschetinian v. City Trust Co.*, 186 N.Y. 432, 79 N.E. 401 (1906); *Davidge v. Guardian Trust Co. of New York*, 203 N.Y. 331, 96 N.E. 751 (1911).

3. The charter or an applicable statute may affect the capacity of a bank or other corporation undertaking to act as an authenticating trustee, registrar, or transfer agent. See, for example, the Federal Reserve Act (U.S.C.A., Title 12, Banks and Banking, Section 248) under which the Board of Governors of the Federal Reserve Bank is authorized to grant special permits to National Banks permitting them to act as trustees. Such corporations are therefore held to certify as to their legal capacity to act as well as to their authority.

4. Authenticating trustees, registrars, and transfer agents have normally been held liable for an issue in excess of the authorized amount. *Jarvis v. Manhattan Beach Co.*, supra; *Mullen v. Eastern Trust & Banking Co.*, 108 Me. 498, 81 A. 948 (1911). In imposing upon these parties a duty of due care with respect to the amount they are authorized to help issue, this section does not necessarily validate the security, but merely holds persons responsible for the excess issue liable in damages for any loss suffered by the purchaser.

5. Aside from questions of genuineness and excess issue, these parties are not held to certify as to the validity of the security unless they specifically undertake to do so. The case law which has recognized a unique responsibility on the transfer agent's part to testify as to the validity of any security which it countersigns is rejected.

6. This provision does not prevent a transfer agent or [issuer](#) from agreeing with a registrar of stock to protect the registrar in respect of the genuineness and proper form of a [security certificate](#) signed by the issuer or the transfer agent or both. Nor does it interfere with proper indemnity arrangements between the issuer and trustees, transfer agents, registrars, and the like.

7. An unauthorized signature is a signature for purposes of this section if and only if it is made effective by Section [8-205](#).

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Genuine" § [1-201\(18\)](#)

"Issuer" § [8-201](#)

"Notice" § [1-201\(25\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-209](#)

This section is similar to Sections [8-202](#) and [8-204](#) which require that the terms of a certificated security and any restriction on transfer imposed by the [issuer](#) be noted on the [security certificate](#). This section differs from those two sections in that the purchaser's knowledge of the issuer's claim is irrelevant. "Noted" makes clear that the text of the lien provisions need not be set forth in full. However, this would not override a provision of an applicable corporation code requiring statement in haec verba. This section does not apply to [uncertificated securities](#). It applies to the indirect holding system in the same fashion as Sections [8-202](#) and [8-204](#), see Comment 2 to Section [8-202](#).

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Issuer" § [8-201](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-210](#)

1. Deeply embedded in corporation law is the conception that "corporate power" to issue [securities](#) stems from the statute, either general or special, under which the corporation is organized. Corporation codes universally require that the charter or articles of incorporation state, at least as to capital shares, maximum limits in terms of number of shares or total dollar capital. Historically, special

incorporation statutes are similarly drawn and sometimes similarly limit the face amount of authorized debt securities. The theory is that issue of securities in excess of the authorized amounts is prohibited. See, for example, *McWilliams v. Geddes & Moss Undertaking Co.*, 169 So. 894 (1936, La.); *Crawford v. Twin City Oil Co.*, 216 Ala. 216, 113 So. 61 (1927); *New York and New Haven R.R. Co. v. Schuyler*, 34 N.Y. 30 (1865). This conception persists despite modern corporation codes under which, by action of directors and stockholders, additional shares can be authorized by charter amendment and thereafter issued. This section does not give a person entitled to validation, issue, or reissue of a security, the right to compel amendment of the charter to authorize additional shares. Therefore, in a case where issue of an additional security would require charter amendment, the plaintiff is limited to the two alternate remedies set forth in subsections (c) and (d). The last clause of subsection (a), which is added in Revised Article 8, does, however, recognize that under modern conditions, [overissue](#) may be a relatively minor technical problem that can be cured by appropriate action under governing corporate law.

2. Where an identical security is reasonably available for purchase, whether because traded on an organized market, or because one or more security owners may be willing to sell at a not unreasonable price, the [issuer](#), although unable to issue additional shares, will be able to purchase them and may be compelled to follow that procedure. *West v. Tintic Standard Mining Co.*, 71 Utah 158, 263 P. 490 (1928).

3. The right to recover damages from an issuer who has permitted an [overissue](#) to occur is well settled. *New York and New Haven R.R. Co. v. Schuyler*, 34 N.Y. 30 (1865). The measure of such damages, however, has been open to question, some courts basing them upon the value of stock at the time registration is refused; some upon the value at the time of trial; and some upon the highest value between the time of refusal and the time of trial. *Allen v. South Boston Railroad*, 150 Mass. 200, 22 N.E. 917, 5 L.R.A. 716, 15 Am.St.Rep. 185 (1889); *Commercial Bank v. Kortright*, 22 Wend. (N.Y.) 348 (1839). The purchase price of the security to the last purchaser who gave value for it is here adopted as being the fairest means of reducing the possibility of speculation by the purchaser. Interest may be recovered as the best available measure of compensation for delay.

Definitional Cross References

"Issuer" § [8-201](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-301](#)

1. This section specifies the requirements for "delivery" of securities. Delivery is used in Article 8 to describe the formal steps necessary for a purchaser to acquire

a direct interest in a security under this Article. The concept of delivery refers to the implementation of a transaction, not the legal categorization of the transaction which is consummated by delivery. Issuance and transfer are different kinds of transaction, though both may be implemented by delivery. Sale and pledge are different kinds of transfers, but both may be implemented by delivery.

2. Subsection (a) defines delivery with respect to [certificated securities](#). Paragraph (1) deals with simple cases where purchasers themselves acquire physical possession of certificates. Paragraphs (2) and (3) of subsection (a) specify the circumstances in which delivery to a purchaser can occur although the certificate is in the possession of a person other than the purchaser. Paragraph (2) contains the general rule that a purchaser can take delivery through another person, so long as the other person is actually acting on behalf of the purchaser or acknowledges that it is holding on behalf of the purchaser. Paragraph (2) does not apply to acquisition of possession by a [securities intermediary](#), because a person who holds securities through a [securities account](#) acquires a [security entitlement](#), rather than having a direct interest. See Section [8-501](#). Subsection (a)(3) specifies the limited circumstances in which delivery of [security certificates](#) to a securities intermediary is treated as a delivery to the customer.

3. Subsection (b) defines [delivery](#) with respect to uncertificated securities. Use of the term "delivery" with respect to uncertificated securities, does, at least on first hearing, seem a bit solecistic. The word "delivery" is, however, routinely used in the securities business in a broader sense than manual tradition. For example, settlement by entries on the books of a [clearing corporation](#) is commonly called "delivery," as in the expression "delivery versus payment." The diction of this section has the advantage of using the same term for uncertificated securities as for [certificated securities](#), for which delivery is conventional usage. Paragraph (1) of subsection (b) provides that delivery occurs when the purchaser becomes the registered owner of an uncertificated security, either upon original issue or registration of transfer. Paragraph (2) provides for delivery of an uncertificated security through a third person, in a fashion analogous to subsection (a)(2).

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Effective" § [8-107](#)

"Issuer" § [8-201](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Special indorsement" § [8-304\(a\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-302](#)

1. Subsection (a) provides that if a certificated or [uncertificated security](#) is delivered (Section [8-301](#)) to a purchaser in a transfer, the purchaser acquires all rights that the transferor had or had power to transfer. This statement of the familiar "shelter" principle is qualified by the exceptions that a purchaser of a limited interest acquires only that interest, subsection (b), and that a person who does not qualify as a protected purchaser cannot improve its position by taking from a subsequent [protected purchaser](#), subsection (c).

2. Although this section provides that a purchaser acquires a property interest in a certificated or uncertificated security upon "[delivery](#)," it does not state that a person can acquire an interest in a security only by delivery. Article 8 is not a comprehensive codification of all of the law governing the creation or transfer of interests in securities. For example, the grant of a security interest is a transfer of a property interest, but the formal steps necessary to effectuate such a transfer are governed by Article 9 not by Article 8. Under the Article 9 rules, a security interest in a certificated or uncertificated security can be created by execution of a security agreement under Section [9-203](#) and can be perfected by filing. A transfer of an Article 9 security interest can be implemented by an Article 8 delivery, but need not be.

Similarly, Article 8 does not determine whether a property interest in certificated or uncertificated security is acquired under other law, such as the law of gifts, trusts, or equitable remedies. Nor does Article 8 deal with transfers by operation of law. For example, transfers from decedent to administrator, from ward to guardian, and from bankrupt to trustee in bankruptcy are governed by other law as to both the time they occur and the substance of the transfer. The Article 8 rules do, however, determine whether the [issuer](#) is obligated to recognize the rights that a third party, such as a transferee, may acquire under other law. See Sections [8-207](#), [8-401](#), and [8-404](#).

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Notice of adverse claim" § [8-105](#)

"Protected purchaser" § [8-303](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

"Delivery" § [8-301](#)

Official Comment [§ 8-303](#)

1. Subsection (a) lists the requirements that a purchaser must meet to qualify as a "[protected purchaser](#)." Subsection (b) provides that a protected purchaser takes its interest free from adverse claims. "Purchaser" is defined broadly in Section [1-201](#). A secured party as well as an outright buyer can qualify as a protected purchaser. Also, "purchase" includes taking by issue, so a person to whom a [security](#) is originally issued can qualify as a protected purchaser.

2. To qualify as a protected purchaser, a purchaser must give value, take without [notice of any adverse claim](#), and obtain control. Value is used in the broad sense defined in Section [1-201\(44\)](#). See also Section [8-116](#) ([securities intermediary](#) as purchaser for value). Adverse claim is defined in Section [8-102\(a\)\(1\)](#). Section [8-105](#) specifies whether a purchaser has notice of an adverse claim. Control is defined in Section [8-106](#). To qualify as a protected purchaser there must be a time at which all of the requirements are satisfied. Thus if a purchaser obtains notice of an adverse claim before giving value or satisfying the requirements for control, the purchaser cannot be a protected purchaser. See also Section [8-304\(d\)](#).

The requirement that a protected purchaser obtain control expresses the point that to qualify for the adverse claim cut-off rule a purchaser must take through a transaction that is implemented by the appropriate mechanism. By contrast, the rules in Part 2 provide that any purchaser for value of a [security](#) without notice of a defense may take free of the [issuer's](#) defense based on that defense. See Section [8-202](#).

3. The requirements for control differ depending on the form of the security. For securities represented by bearer certificates, a purchaser obtains control by [delivery](#). See Sections [8-106\(a\)](#) and [8-301\(a\)](#). For securities represented by certificates in [registered form](#), the requirements for control are: (1) delivery as defined in Section [8-301\(b\)](#), plus (2) either an [effective indorsement](#) or registration of transfer by the issuer. See Section [8-106\(b\)](#). Thus, a person who takes through a forged indorsement does not qualify as a [protected purchaser](#) by virtue of the delivery alone. If, however, the purchaser presents the certificate to the issuer for registration of transfer, and the issuer registers transfer over the forged indorsement, the purchaser can qualify as a protected purchaser of the new certificate. If the issuer registers transfer on a forged indorsement, the true owner will be able to recover from the issuer for wrongful registration, see Section [8-404](#), unless the owner's delay in notifying the issuer of a loss or theft of the certificate results in preclusion under Section [8-406](#).

For [uncertificated securities](#), a purchaser can obtain control either by delivery, see Sections [8-106\(c\)\(1\)](#) and [8-301\(b\)](#), or by obtaining an agreement pursuant to which the issuer agrees to act on [instructions](#) from the purchaser without further consent from the registered owner, see Section [8-106\(c\)\(2\)](#). The control agreement device of Section [8-106\(c\)\(2\)](#) takes the place of the "registered pledge" concept of the 1978 version of Article 8. A secured lender who obtains a control agreement under Section [8-106\(c\)\(2\)](#) can qualify as a protected purchaser of an uncertificated security.

4. This section states directly the rules determining whether one takes free from adverse claims without using the phrase "[good faith](#)." Whether a person who takes under suspicious circumstances is disqualified is determined by the rules of Section [8-105](#) on notice of adverse claims. The term "[protected purchaser](#)," which replaces the term "bona fide purchaser" used in the prior version of Article 8, is derived from the term "protected holder" used in the Convention on International Bills and Notes prepared by the United Nations Commission on International Trade Law ("UNCITRAL").

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Control" § [8-106](#)

"Notice of adverse claim" § [8-105](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-304](#)

1. By virtue of the definition of [indorsement](#) in Section [8-102](#) and the rules of this section, the simplified method of indorsing [certificated securities](#) previously set forth in the Uniform Stock Transfer Act is continued. Although more than one [special indorsement](#) on a given [security certificate](#) is possible, the desire for dividends or interest, as the case may be, should operate to bring the certificate home for registration of transfer within a reasonable period of time. The usual form of assignment which appears on the back of a stock certificate or in a separate "power" may be filled up either in the form of an assignment, a power of attorney to transfer, or both. If it is not filled up at all but merely signed, the indorsement is in blank. If filled up either as an assignment or as a power of attorney to transfer, the indorsement is special.

2. Subsection (b) recognizes the validity of a "partial" [indorsement](#), e.g., as to fifty shares of the one hundred represented by a single certificate. The rights of a transferee under a partial indorsement to the status of a [protected purchaser](#) are left to the case law.

3. Subsection (c) deals with the effect of an [indorsement](#) without [delivery](#). There must be a voluntary parting with control in order to effect a valid transfer of a certificated security as between the parties. *Levey v. Nason*, 279 Mass. 268, 181 N.E. 193 (1932), and *National Surety Co. v. Indemnity Insurance Co. of North America*, 237 App.Div. 485, 261 N.Y.S. 605 (1933). The provision in Section 10 of the Uniform Stock Transfer Act that an attempted transfer without delivery amounts to a promise to transfer is omitted. Even under that Act the

effect of such a promise was left to the applicable law of contracts, and this Article by making no reference to such situations intends to achieve a similar result. With respect to delivery there is no counterpart to subsection (d) on right to compel indorsement, such as is envisaged in *Johnson v. Johnson*, 300 Mass. 24, 13 N.E.2d 788 (1938), where the transferee under a written assignment was given the right to compel a transfer of the certificate.

4. Subsection (d) deals with the effect of delivery without [indorsement](#). As between the parties the transfer is made complete upon delivery, but the transferee cannot become a protected purchaser until indorsement is made. The indorsement does not operate retroactively, and notice may intervene between delivery and indorsement so as to prevent the transferee from becoming a protected purchaser. Although a purchaser taking without a necessary indorsement may be subject to claims of ownership, any [issuer's](#) defense of which the purchaser had no notice at the time of delivery will be cut off, since the provisions of this Article protect all purchasers for value without notice (Section [8-202](#)).

The transferee's right to compel an [indorsement](#) where a [security certificate](#) has been delivered with intent to transfer is recognized in the case law. See *Coats v. Guaranty Bank & Trust Co.*, 170 La. 871, 129 So. 513 (1930). A proper indorsement is one of the requisites of transfer which a purchaser of a certificated security has a right to obtain (Section [8-307](#)). A purchaser may not only compel an indorsement under that section but may also recover for any reasonable expense incurred by the transferor's failure to respond to the demand for an indorsement.

5. Subsection (e) deals with the significance of an [indorsement](#) on a [security certificate](#) in bearer form. The concept of indorsement applies only to registered securities. A purported indorsement of bearer paper is normally of no effect. An indorsement "for collection," "for surrender" or the like, charges a purchaser with notice of adverse claims (Section [8-105\(d\)](#)) but does not operate beyond this to interfere with any right the holder may otherwise possess to have the security registered.

6. Subsection (f) makes clear that the indorser of a [security certificate](#) does not warrant that the [issuer](#) will honor the underlying obligation. In view of the nature of investment securities and the circumstances under which they are normally transferred, a transferor cannot be held to warrant as to the issuer's actions. As a transferor the indorser, of course, remains liable for breach of the warranties set forth in this Article (Section [8-108](#)).

Definitional Cross References

"Bearer form" § [8-102\(a\)\(2\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-305](#)

1. The term [instruction](#) is defined in Section [8-102\(a\)\(12\)](#) as a notification [communicated](#) to the [issuer](#) of an [uncertificated security](#) directing that transfer be registered. Section [8-107](#) specifies who may initiate an [effective](#) instruction.

Functionally, presentation of an instruction is quite similar to the presentation of an indorsed certificate for reregistration. Note that instruction is defined in terms of "[communicate](#)," see Section [8-102\(a\)\(6\)](#). Thus, the instruction may be in the form of a writing signed by the registered owner or in any other form agreed upon by the issuer and the registered owner. Allowing nonwritten forms of instructions will permit the development and employment of means of transmitting instructions electronically.

When a person who originates an instruction leaves a blank and the blank later is completed, subsection (a) gives the issuer the same rights it would have had against the originating person had that person completed the blank. This is true regardless of whether the person completing the instruction had authority to complete it. Compare Section [8-206](#) and its Comment, dealing with blanks left upon issue.

2. Subsection (b) makes clear that the originator of an instruction, like the indorser of a [security certificate](#), does not warrant that the issuer will honor the underlying obligation, but does make warranties as a transferor under Section [8-108](#).

Definitional Cross References

"Appropriate person" § [8-107](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

Official Comment [§ 8-306](#)

1. Subsection (a) provides that a guarantor of the signature of the indorser of a [security certificate](#) warrants that the signature is genuine, that the signer is an [appropriate person](#) or has actual authority to indorse on behalf of the appropriate person, and that the signer has legal capacity. Subsection (b) provides similar, though not identical, warranties for the guarantor of a signature of the originator of an [instruction](#) for transfer of an [uncertificated security](#).

[Appropriate person](#) is defined in Section [8-107\(a\)](#) to include a successor or person who has power under other law to act for a person who is deceased or lacks capacity. Thus if a certificate registered in the name of Mary Roe is

indorsed by Jane Doe as executor of Mary Roe, a guarantor of the signature of Jane Doe warrants that she has power to act as executor.

Although the definition of [appropriate person](#) in Section [8-107\(a\)](#) does not itself include an agent, an [indorsement](#) by an agent is [effective](#) under Section [8-107\(b\)](#) if the agent has authority to act for the appropriate person. Accordingly, this section provides an explicit warranty of authority for agents.

2. The rationale of the principle that a signature guarantor warrants the authority of the signer, rather than simply the genuineness of the signature, was explained in the leading case of *Jennie Clarkson Home for Children v. Missouri, K. & T. R. Co.*, 182 N.Y. 47, 74 N.E. 571, 70 A.L.R. 787 (1905), which dealt with a guaranty of the signature of a person indorsing on behalf of a corporation. "If stock is held by an individual who is executing a power of attorney for its transfer, the member of the exchange who signs as a witness thereto guaranties not only the genuineness of the signature affixed to the power of attorney, but that the person signing is the individual in whose name the stock stands. With reference to stock standing in the name of a corporation, which can only sign a power of attorney through its authorized officers or agents, a different situation is presented. If the witnessing of the signature of the corporation is only that of the signature of a person who signs for the corporation, then the guaranty is of no value, and there is nothing to protect purchasers or the companies who are called upon to issue new stock in the place of that transferred from the frauds of persons who have signed the names of corporations without authority. If such is the only effect of the guaranty, purchasers and transfer agents must first go to the corporation in whose name the stock stands and ascertain whether the individual who signed the power of attorney had authority to so do. This will require time, and in many cases will necessitate the postponement of the completion of the purchase by the payment of the money until the facts can be ascertained. The [broker](#) who is acting for the owner has an opportunity to become acquainted with his customer, and may readily before sale ascertain, in case of a corporation, the name of the officer who is authorized to execute the power of attorney. It was therefore, we think, the purpose of the rule to cast upon the broker who witnesses the signature the duty of ascertaining whether the person signing the name of the corporation had authority to so do, and making the witness a guarantor that it is the signature of the corporation in whose name the stock stands."

3. Subsection (b) sets forth the warranties that can reasonably be expected from the guarantor of the signature of the originator of an [instruction](#), who, though familiar with the signer, does not have any evidence that the purported owner is in fact the owner of the subject [uncertificated security](#). This is in contrast to the position of the person guaranteeing a signature on a certificate who can see a certificate in the signer's possession in the name of or indorsed to the signer or in blank. Thus, the warranty in paragraph (2) of subsection (b) is expressly conditioned on the actual registration's conforming to that represented by the originator. If the signer purports to be the owner, the guarantor under paragraph (2), warrants only the identity of the signer. If, however, the signer is acting in a representative capacity, the guarantor warrants both the signer's identity and authority to act for the purported owner. The [issuer](#) needs no warranty as to the facts of registration because those facts can be ascertained from the issuer's own records.

4. Subsection (c) sets forth a "special guaranty of signature" under which the guarantor additionally warrants both registered ownership and freedom from undisclosed defects of record. The guarantor of the signature of an indorser of a [security certificate](#) effectively makes these warranties to a purchaser for value on the evidence of a clean certificate issued in the name of the indorser, indorsed to the indorser or indorsed in blank. By specially guaranteeing under subsection (c), the guarantor warrants that the [instruction](#) will, when presented to the [issuer](#), result in the requested registration free from defects not specified.

5. Subsection (d) makes clear that the warranties of a signature guarantor are limited to those specified in this section and do not include a general warranty of rightfulness. On the other hand subsections (e) and (f) provide that a person guaranteeing an [indorsement](#) or an instruction does warrant that the transfer is rightful in all respects.

6. Subsection (g) makes clear what can be inferred from the combination of Sections [8-401](#) and [8-402](#), that the issuer may not require as a condition to transfer a guaranty of the [indorsement](#) or instruction nor may it require a special signature guaranty.

7. Subsection (h) specifies to whom the warranties in this section run, and also provides that a person who gives a guaranty under this section has an action against the indorser or originator for any loss suffered by the guarantor.

Definitional Cross References

"Appropriate person" § [8-107](#)

"Genuine" § [1-201\(18\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-307](#)

1. Because registration of the transfer of a security is a matter of vital importance, a purchaser is here provided with the means of obtaining such formal requirements for registration as signature guaranties, proof of authority, transfer tax stamps and the like. The transferor is the one in a position to supply most conveniently whatever documentation may be requisite for registration of transfer, and the duty to do so upon demand within a reasonable time is here stated affirmatively. If an essential item is peculiarly within the province of the transferor so that the transferor is the only one who can obtain it, the purchaser

may specifically enforce the right to obtain it. Compare Section [8-304\(d\)](#). If a transfer is not for value the transferor need not pay expenses.

2. If the transferor's duty is not performed the transferee may reject or rescind the contract to transfer. The transferee is not bound to do so. An action for damages for breach of contract may be preferred.

Definitional Cross References

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Security" § [8-102\(a\)\(15\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-401](#)

1. This section states the duty of the [issuer](#) to register transfers. A duty exists only if certain preconditions exist. If any of the preconditions do not exist, there is no duty to register transfer. If an [indorsement](#) on a [security certificate](#) is a forgery, there is no duty. If an [instruction](#) to transfer an [uncertificated security](#) is not originated by an [appropriate person](#), there is no duty. If there has not been compliance with applicable tax laws, there is no duty. If a security certificate is properly indorsed but nevertheless the transfer is in fact wrongful, there is no duty unless the transfer is to a [protected purchaser](#) (and the other preconditions exist).

This section does not constitute a mandate that the [issuer](#) must establish that all preconditions are met before the issuer registers a transfer. The issuer may waive the reasonable assurances specified in paragraph (a)(3). If it has confidence in the responsibility of the persons requesting transfer, it may ignore questions of compliance with tax laws. Although an issuer has no duty if the transfer is wrongful, the issuer has no duty to inquire into adverse claims, see Section [8-404](#).

2. By subsection (b) the person entitled to registration may not only compel it but may hold the issuer liable in damages for unreasonable delay.

3. Section [8-201\(c\)](#) provides that with respect to registration of transfer, "issuer" means the person on whose behalf transfer books are maintained. Transfer agents, registrars or the like within the scope of their respective functions have rights and duties under this Part similar to those of the issuer. See Section [8-407](#).

Definitional Cross References

"Appropriate person" § [8-107](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Genuine" § [1-201\(18\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Protected purchaser" § [8-303](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-402](#)

1. An [issuer](#) is absolutely liable for wrongful registration of transfer if the [indorsement](#) or [instruction](#) is ineffective. See Section [8-404](#). Accordingly, an issuer is entitled to require such assurance as is reasonable under the circumstances that all necessary indorsements are [effective](#), and thus to minimize its risk. This section establishes the requirements the issuer may make in terms of documentation which, except in the rarest of instances, should be easily furnished. Subsection (b) provides that an issuer may require additional assurances if that requirement is reasonable under the circumstances, but if the issuer demands more than reasonable assurance that the instruction or the necessary indorsements are genuine and authorized, the presenter may refuse the demand and sue for improper refusal to register. Section [8-401\(b\)](#).

2. Under subsection (a)(1), the issuer may require in all cases a guaranty of signature. See Section [8-306](#). When an instruction is presented the issuer always may require reasonable assurance as to the identity of the originator. Subsection (c) allows the issuer to require that the person making these guaranties be one reasonably believed to be responsible, and the issuer may adopt standards of responsibility which are not manifestly unreasonable. Regulations under the federal [securities](#) laws, however, place limits on the requirements transfer agents may impose concerning the responsibility of eligible signature guarantors. See 17 CFR 240.17Ad-15.

3. This section, by paragraphs (2) through (5) of subsection (a), permits the [issuer](#) to seek confirmation that the [indorsement](#) or [instruction](#) is genuine and authorized. The permitted methods act as a double check on matters which are within the warranties of the signature guarantor. See Section [8-306](#). Thus, an agent may be required to submit a power of attorney, a corporation to submit a certified resolution evidencing the authority of its signing officer to sign, an executor or administrator to submit the usual "short-form certificate," etc. But failure of a fiduciary to obtain court approval of the transfer or to comply with other requirements does not make the fiduciary's signature ineffective. Section [8-107\(c\)](#). Hence court orders and other controlling instruments are omitted from subsection (a).

Subsection (a)(3) authorizes the [issuer](#) to require "appropriate evidence" of appointment or incumbency, and subsection (c) indicates what evidence will be "appropriate". In the case of a fiduciary appointed or qualified by a court that evidence will be a court certificate dated within sixty days before the date of presentation, subsection (c)(2)(i). Where the fiduciary is not appointed or qualified by a court, as in the case of a successor trustee, subsection (c)(2)(ii) applies. In that case, the issuer may require a copy of a trust instrument or other document showing the appointment, or it may require the certificate of a responsible person. In the absence of such a document or certificate, it may require other appropriate evidence. If the security is registered in the name of the fiduciary as such, the person's signature is effective even though the person is no longer serving in that capacity, see Section [8-107\(d\)](#), hence no evidence of incumbency is needed.

4. Circumstances may indicate that a necessary signature was unauthorized or was not that of an [appropriate person](#). Such circumstances would be ignored at risk of absolute liability. To minimize that risk the [issuer](#) may properly exercise the option given by subsection (b) to require assurance beyond that specified in subsection (a). On the other hand, the facts at hand may reflect only on the rightfulness of the transfer. Such facts do not create a duty of inquiry, because the issuer is not liable to an adverse claimant unless the claimant obtains legal process. See Section [8-404](#).

Definitional Cross References

"Appropriate person" § [8-107](#)

"Genuine" § [1-201\(18\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

Official Comment [§ 8-403](#)

1. The general rule under this Article is that if there has been an [effective indorsement](#) or [instruction](#), a person who contends that registration of the transfer would be wrongful should not be able to interfere with the registration process merely by sending notice of the assertion to the [issuer](#). Rather, the claimant must obtain legal process. See Section [8-404](#). Section 8-403 is an exception to this general rule. It permits the registered owner -- but not third parties -- to demand that the issuer not register a transfer.

2. This section is intended to alleviate the problems faced by registered owners of [certificated securities](#) who lose or misplace their certificates. A registered owner who realizes that a certificate may have been lost or stolen should promptly report that fact to the issuer, lest the owner be precluded from asserting a claim for wrongful registration. See Section [8-406](#). The usual practice of issuers and transfer agents is that when a certificate is reported as

lost, the owner is notified that a replacement can be obtained if the owner provides an indemnity bond. See Section [8-405](#). If the registered owner does not plan to transfer the securities, the owner might choose not to obtain a replacement, particularly if the owner suspects that the certificate has merely been misplaced.

Under this section, the owner's notification that the certificate has been lost would constitute a demand that the [issuer](#) not register transfer. No indemnity bond or legal process is necessary. If the original certificate is presented for registration of transfer, the issuer is required to notify the registered owner of that fact, and defer registration of transfer for a stated period. In order to prevent undue delay in the process of registration, the stated period may not exceed thirty days. This gives the registered owner an opportunity to either obtain legal process or post an indemnity bond and thereby prevent the issuer from registering transfer.

3. Subsection (e) makes clear that this section does not relieve an issuer from liability for registering a transfer pursuant to an ineffective [indorsement](#). An issuer's liability for wrongful registration in such cases does not depend on the presence or absence of notice that the indorsement was ineffective. Registered owners who are confident that they neither indorsed the certificates, nor did anything that would preclude them from denying the effectiveness of another's indorsement, see Sections [8-107\(b\)](#) and [8-406](#), might prefer to pursue their rights against the issuer for wrongful registration rather than take advantage of the opportunity to post a bond or seek a restraining order when notified by the issuer under this section that their lost certificates have been presented for registration in apparently good order.

Definitional Cross References

"Appropriate person" § [8-107](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Communicate" § [8-102\(a\)\(6\)](#)

"Effective" § [8-107](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-404](#)

1. Subsection (a)(1) provides that an [issuer](#) is liable if it registers transfer pursuant to an [indorsement](#) or [instruction](#) that was not [effective](#). For example, an issuer that registers transfer on a forged indorsement is liable to the registered owner. The fact that the issuer had no reason to suspect that the indorsement was forged or that the issuer obtained the ordinary assurances under Section [8-402](#) does not relieve the issuer from liability. The reason that issuers obtain signature guaranties and other assurances is that they are liable for wrongful registration.

Subsection (b) specifies the remedy for wrongful registration. Pre-Code cases established the registered owner's right to receive a new security where the [issuer](#) had wrongfully registered a transfer, but some cases also allowed the registered owner to elect between an equitable action to compel issue of a new security and an action for damages. Cf. *Casper v. Kalt-Zimmers Mfg. Co.*, 159 Wis. 517, 149 N.W. 754 (1914). Article 8 does not allow such election. The true owner of a certificated security is required to take a new security except where an [overissue](#) would result and a similar security is not reasonably available for purchase. See Section [8-210](#). The true owner of an [uncertificated security](#) is entitled and required to take restoration of the records to their proper state, with a similar exception for overissue.

2. Read together, subsections (c) and (a) have the effect of providing that an [issuer](#) has no duties to an adverse claimant unless the claimant serves legal process on the issuer to enjoin registration. Issuers, or their transfer agents, perform a record-keeping function for the direct holding system that is analogous to the functions performed by clearing corporations and securities intermediaries in the indirect holding system. This section applies to the record-keepers for the direct holding system the same standard that Section [8-115](#) applies to the record-keepers for the indirect holding system. Thus, issuers are not liable to adverse claimants merely on the basis of notice. As in the case of the analogous rules for the indirect holding system, the policy of this section is to protect the right of investors to have their securities transfers processed without the disruption or delay that might result if the record-keepers risked liability to third parties. It would be undesirable to apply different standards to the direct and indirect holding systems, since doing so might operate as a disincentive to the development of a book-entry direct holding system.

3. This section changes prior law under which an [issuer](#) could be held liable, even though it registered transfer on an [effective indorsement](#) or [instruction](#), if the issuer had in some fashion been notified that the transfer might be wrongful against a third party, and the issuer did not appropriately discharge its duty to inquire into the adverse claim. See Section [8-403](#) (1978).

The rule of former Section [8-403](#) was anomalous inasmuch as Section [8-207](#) provides that the [issuer](#) is entitled to "treat the registered owner as the person exclusively entitled to vote, receive notifications, and otherwise exercise all the rights and powers of an owner." Under Section [8-207](#), the fact that a third person notifies the issuer of a claim does not preclude the issuer from treating the registered owner as the person entitled to the security. See *Kerrigan v. American Orthodontics Corp.*, 960 F.2d 43 (7th Cir. 1992). The change made in the present version of Section [8-404](#) ensures that the rights of registered owners and the duties of issuers with respect to registration of transfer will be protected

against third-party interference in the same fashion as other rights of registered ownership.

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Effective" § [8-107](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Instruction" § [8-102\(a\)\(12\)](#)

"Issuer" § [8-201](#)

"Security" § [8-102\(a\)\(15\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-405](#)

1. This section enables the owner to obtain a replacement of a lost, destroyed or stolen certificate, provided that reasonable requirements are satisfied and a sufficient indemnity bond supplied.

2. Where an "original" [security certificate](#) has reached the hands of a [protected purchaser](#), the registered owner -- who was in the best position to prevent the loss, destruction or theft of the security certificate -- is now deprived of the new security certificate issued as a replacement. This changes the pre-UCC law under which the original certificate was ineffective after the issue of a replacement except insofar as it might represent an action for damages in the hands of a purchaser for value without notice. *Keller v. Eureka Brick Mach. Mfg. Co.*, 43 Mo.App. 84, 11 L.R.A. 472 (1890). Where both the original and the new certificate have reached protected purchasers the [issuer](#) is required to honor both certificates unless an [overissue](#) would result and the security is not reasonably available for purchase. See Section [8-210](#). In the latter case alone, the protected purchaser of the original certificate is relegated to an action for damages. In either case, the issuer itself may recover on the indemnity bond.

Definitional Cross References

"Bearer form" § [8-102\(a\)\(2\)](#)

"Certificated security" § [8-102\(a\)\(4\)](#)

"Issuer" § [8-201](#)

"Notice" § [1-201\(25\)](#)

"Overissue" § [8-210](#)

"Protected purchaser" § [8-303](#)

"Registered form" § [8-102\(a\)\(13\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-406](#)

An owner who fails to notify the [issuer](#) within a reasonable time after the owner knows or has reason to know of the loss or theft of a [security certificate](#) is estopped from asserting the ineffectiveness of a forged or unauthorized [indorsement](#) and the wrongfulness of the registration of the transfer. If the lost certificate was indorsed by the owner, then the registration of the transfer was not wrongful under Section [8-404](#), unless the owner made an effective demand that the issuer not register transfer under Section [8-403](#).

Definitional Cross References

"Issuer" § [8-201](#)

"Notify" § [1-201\(25\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

Official Comment [§ 8-407](#)

1. Transfer agents, registrars, and the like are here expressly held liable both to the [issuer](#) and to the owner for wrongful refusal to register a transfer as well as for wrongful registration of a transfer in any case within the scope of their respective functions where the issuer would itself be liable. Those cases which have regarded these parties solely as agents of the issuer and have therefore refused to recognize their liability to the owner for mere non-feasance, i.e., refusal to register a transfer, are rejected. *Hulse v. Consolidated Quicksilver Mining Corp.*, 65 Idaho 768, 154 P.2d 149 (1944); *Nicholson v. Morgan*, 119 Misc. 309, 196 N.Y.Supp. 147 (1922); *Lewis v. Hargadine-McKittrick Dry Goods Co.*, 305 Mo. 396, 274 S.W. 1041 (1924).

2. The practice frequently followed by authenticating trustees of issuing certificates of indebtedness rather than authenticating duplicate certificates where securities have been lost or stolen became obsolete in view of the provisions of Section [8-405](#), which makes express provision for the issue of substitute securities. It is not a breach of trust or lack of due diligence for trustees to authenticate new securities. Cf. *Switzerland General Ins. Co. v. N.Y.C. & H.R.R. Co.*, 152 App.Div. 70, 136 N.Y.S. 726 (1912).

Definitional Cross References

"Certificated security" § [8-102\(a\)\(4\)](#)

"Issuer" § [8-201](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security certificate" § [8-102\(a\)\(16\)](#)

"Uncertificated security" § [8-102\(a\)\(18\)](#)

Official Comment [§ 8-501](#)

1. Part 5 rules apply to security entitlements, and Section 8-501(b) provides that a person has a [security entitlement](#) when a [financial asset](#) has been credited to a "securities account." Thus, the term "securities account" specifies the type of arrangements between institutions and their customers that are covered by Part 5. A securities account is a consensual arrangement in which the intermediary undertakes to treat the customer as entitled to exercise the rights that comprise the financial asset. The consensual aspect is covered by the requirement that the account be established pursuant to agreement. The term agreement is used in the broad sense defined in Section [1-201\(3\)](#). There is no requirement that a formal or written agreement be signed.

As the securities business is presently conducted, several significant relationships clearly fall within the definition of a securities account, including the relationship between a [clearing corporation](#) and its participants, a [broker](#) and customers who leave [securities](#) with the broker, and a bank acting as securities custodian and its custodial customers. Given the enormous variety of arrangements concerning securities that exist today, and the certainty that new arrangements will evolve in the future, it is not possible to specify all of the arrangements to which the term does and does not apply.

Whether an arrangement between a firm and another person concerning a security or other [financial asset](#) is a "securities account" under this Article depends on whether the firm has undertaken to treat the other person as entitled to exercise the rights that comprise the security or other financial asset. Section [1-102](#), however, states the fundamental principle of interpretation that the Code provisions should be construed and applied to promote their underlying purposes and policies. Thus, the question whether a given arrangement is a securities account should be decided not by dictionary analysis of the words of the definition taken out of context, but by considering whether it promotes the objectives of Article 8 to include the arrangement within the term securities account.

The effect of concluding that an arrangement is a securities account is that the rules of Part 5 apply. Accordingly, the definition of "securities account" must be interpreted in light of the substantive provisions in Part 5, which describe the core features of the type of relationship for which the commercial law rules of Revised Article 8 concerning security entitlements were designed. There are many arrangements between institutions and other persons concerning securities or other [financial assets](#) which do not fall within the definition of "securities account" because the institutions have not undertaken to treat the other persons as entitled to exercise the ordinary rights of an [entitlement holder](#) specified in the Part 5 rules. For example, the term securities account does not cover the relationship between a bank and its depositors or the relationship between a

trustee and the beneficiary of an ordinary trust, because those are not relationships in which the holder of a financial asset has undertaken to treat the other as entitled to exercise the rights that comprise the financial asset in the fashion contemplated by the Part 5 rules.

In short, the primary factor in deciding whether an arrangement is a securities account is whether application of the Part 5 rules is consistent with the expectations of the parties to the relationship. Relationships not governed by Part 5 may be governed by other parts of Article 8 if the relationship gives rise to a new [security](#), or may be governed by other law entirely.

2. Subsection (b) of this section specifies what circumstances give rise to security entitlements. Paragraph (1) of subsection (b) sets out the most important rule. It turns on the intermediary's conduct, reflecting a basic operating assumption of the indirect holding system that once a [securities intermediary](#) has acknowledged that it is carrying a position in a [financial asset](#) for its customer or participant, the intermediary is obligated to treat the customer or participant as entitled to the financial asset. Paragraph (1) does not attempt to specify exactly what accounting, record-keeping, or information transmission steps suffice to indicate that the intermediary has credited the account. That is left to agreement, trade practice, or rule in order to provide the flexibility necessary to accommodate varying or changing accounting and information processing systems. The point of paragraph (1) is that once an intermediary has acknowledged that it is carrying a position for the customer or participant, the customer or participant has a [security entitlement](#). The precise form in which the intermediary manifests that acknowledgment is left to private ordering.

Paragraph (2) of subsection (b) sets out a different operational test, turning not on the intermediary's accounting system but on the facts that accounting systems are supposed to represent. Under paragraph (b)(2) a person has a security entitlement if the intermediary has received and accepted a [financial asset](#) for credit to the account of its customer or participant. For example, if a customer of a [broker](#) or bank custodian delivers a [security certificate](#) in proper form to the broker or bank to be held in the customer's account, the customer acquires a security entitlement. Paragraph (b)(2) also covers circumstances in which the intermediary receives a financial asset from a third person for credit to the account of the customer or participant. Paragraph (b)(2) is not limited to circumstances in which the intermediary receives security certificates or other financial assets in physical form. Paragraph (b)(2) also covers circumstances in which the intermediary acquires a security entitlement with respect to a financial asset which is to be credited to the account of the intermediary's own customer. For example, if a customer transfers her account from Broker A to Broker B, she acquires security entitlements against Broker B once the [clearing corporation](#) has credited the positions to Broker B's account. It should be noted, however, that paragraph (b)(2) provides that a person acquires a security entitlement when the intermediary not only receives but also accepts the financial asset for credit to the account. This limitation is included to take account of the fact that there may be circumstances in which an intermediary has received a financial asset but is not willing to undertake the obligations that flow from establishing a security entitlement. For example, a security certificate which is sent to an intermediary may not be in proper form, or may represent a type of financial asset which the

intermediary is not willing to carry for others. It should be noted that in all but extremely unusual cases, the circumstances covered by paragraph (2) will also be covered by paragraph (1), because the intermediary will have credited the positions to the customer's account.

Paragraph (3) of subsection (b) sets out a residual test, to avoid any implication that the failure of an intermediary to make the appropriate entries to credit a position to a customer's securities account would prevent the customer from acquiring the rights of an [entitlement holder](#) under Part 5. As is the case with the paragraph (2) test, the paragraph (3) test would not be needed for the ordinary cases, since they are covered by paragraph (1).

3. In a sense, Section 8-501(b) is analogous to the rules set out in the provisions of Sections 8-313(1)(d) and 8-320 of the prior version of Article 8 that specified what acts by a [securities intermediary](#) or [clearing corporation](#) sufficed as a transfer of securities held in fungible bulk. Unlike the prior version of Article 8, however, this section is not based on the idea that an [entitlement holder](#) acquires rights only by virtue of a "transfer" from the securities intermediary to the entitlement holder. In the indirect holding system, the significant fact is that the securities intermediary has undertaken to treat the customer as entitled to the [financial asset](#). It is up to the securities intermediary to take the necessary steps to ensure that it will be able to perform its undertaking. It is, for example, entirely possible that a securities intermediary might make entries in a customer's account reflecting that customer's acquisition of a certain security at a time when the securities intermediary did not itself happen to hold any units of that security. The person from whom the securities intermediary bought the security might have failed to deliver and it might have taken some time to clear up the problem, or there may have been an operational gap in time between the crediting of a customer's account and the receipt of securities from another securities intermediary. The entitlement holder's rights against the securities intermediary do not depend on whether or when the securities intermediary acquired its interests. Subsection (c) is intended to make this point clear. Subsection (c) does not mean that the intermediary is free to create security entitlements without itself holding sufficient financial assets to satisfy its entitlement holders. The duty of a securities intermediary to maintain sufficient assets is governed by Section [8-504](#) and regulatory law. Subsection (c) is included only to make it clear the question whether a person has acquired a [security entitlement](#) does not depend on whether the intermediary has complied with that duty.

4. Part 5 of Article 8 sets out a carefully designed system of rules for the indirect holding system. Persons who hold securities through brokers or custodians have security entitlements that are governed by Part 5, rather than being treated as the direct holders of securities. Subsection (d) specifies the limited circumstance in which a customer who leaves a [financial asset](#) with a [broker](#) or other [securities intermediary](#) has a direct interest in the financial asset, rather than a security entitlement.

The customer can be a direct holder only if the [security certificate](#), or other [financial asset](#), is registered in the name of, payable to the order of, or specially indorsed to the customer, and has not been indorsed by the customer to the securities intermediary or in blank. The distinction between those circumstances

where the customer can be treated as direct owner and those where the customer has a security entitlement is essentially the same as the distinction drawn under the federal bankruptcy code between customer name securities and customer property. The distinction does not turn on any form of physical identification or segregation. A customer who delivers certificates to a [broker](#) with blank indorsements or stock powers is not a direct holder but has a [security entitlement](#), even though the broker holds those certificates in some form of separate safe-keeping arrangement for that particular customer. The customer remains the direct holder only if there is no [indorsement](#) or stock power so that further action by the customer is required to place the certificates in a form where they can be transferred by the broker.

The rule of subsection (d) corresponds to the rule set out in Section [8-301\(a\)\(3\)](#) specifying when acquisition of possession of a certificate by a [securities intermediary](#) counts as "[delivery](#)" to the customer.

5. Subsection (e) is intended to make clear that Part 5 does not apply to an arrangement in which a security is issued representing an interest in underlying assets, as distinguished from arrangements in which the underlying assets are carried in a securities account. A common mechanism by which new financial instruments are devised is that a financial institution that holds some security, financial instrument, or pool thereof, creates interests in that asset or pool which are sold to others. In many such cases, the interests so created will fall within the definition of "[security](#)" in Section [8-102\(a\)\(15\)](#). If so, then by virtue of subsection (e) of Section 8-501, the relationship between the institution that creates the interests and the persons who hold them is not a [security entitlement](#) to which the Part 5 rules apply. Accordingly, an arrangement such as an American depository receipt facility which creates freely transferable interests in underlying securities will be issuance of a security under Article 8 rather than establishment of a security entitlement to the underlying securities.

The subsection (e) rule can be regarded as an aspect of the definitional rules specifying the meaning of securities account and [security entitlement](#). Among the key components of the definition of security in Section [8-102\(a\)\(15\)](#) are the "transferability" and "divisibility" tests. Securities, in the Article 8 sense, are fungible interests or obligations that are intended to be tradable. The concept of [security entitlement](#) under Part 5 is quite different. A security entitlement is the package of rights that a person has against the person's own intermediary with respect to the positions carried in the person's securities account. That package of rights is not, as such, something that is traded. When a customer sells a security that she had held through a securities account, her security entitlement is terminated; when she buys a security that she will hold through her securities account, she acquires a security entitlement. In most cases, settlement of a securities trade will involve termination of one person's security entitlement and acquisition of a security entitlement by another person. That transaction, however, is not a "transfer" of the same entitlement from one person to another. That is not to say that an [entitlement holder](#) cannot transfer an interest in her security entitlement as such; granting a security interest in a security entitlement is such a transfer. On the other hand, the nature of a security entitlement is that the intermediary is undertaking duties only to the person identified as the entitlement holder.

Definitional Cross References

"Financial asset" § [8-102\(a\)\(9\)](#)

"Indorsement" § [8-102\(a\)\(11\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security" § [8-102\(a\)\(15\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

Official Comment [§ 8-502](#)

1. The section provides investors in the indirect holding system with protection against adverse claims by specifying that no adverse claim can be asserted against a person who acquires a [security entitlement](#) under Section [8-501](#) for value and without [notice of the adverse claim](#). It plays a role in the indirect holding system analogous to the rule of the direct holding system that [protected purchasers](#) take free from adverse claims (Section [8-303](#)).

This section does not use the locution "takes free from adverse claims" because that could be confusing as applied to the indirect holding system. The nature of indirect holding system is that an [entitlement holder](#) has an interest in common with others who hold positions in the same [financial asset](#) through the same intermediary. Thus, a particular entitlement holder's interest in the financial assets held by its intermediary is necessarily "subject to" the interests of others. See Section [8-503](#). The rule stated in this section might have been expressed by saying that a person who acquires a security entitlement under Section [8-501](#) for value and without notice of adverse claims takes "that security entitlement" free from adverse claims. That formulation has not been used, however, for fear that it would be misinterpreted as suggesting that the person acquires a right to the underlying financial assets that could not be affected by the competing rights of others claiming through common or higher tier intermediaries. A security entitlement is a complex bundle of rights. This section does not deal with the question of what rights are in the bundle. Rather, this section provides that once a person has acquired the bundle, someone else cannot take it away on the basis of assertion that the transaction in which the security entitlement was created involved a violation of the claimant's rights.

2. Because securities trades are typically settled on a net basis by book-entry movements, it would ordinarily be impossible for anyone to trace the path of any particular [security](#), no matter how the interest of parties who hold through intermediaries is described. Suppose, for example, that S has a 1000 share position in XYZ common stock through an account with a [broker](#), Able & Co. S's identical twin impersonates S and directs Able to sell the securities. That same day, B places an order with Baker & Co., to buy 1000 shares of XYZ common stock. Later, S discovers the wrongful act and seeks to recover "her shares." Even if S can show that, at the stage of the trade, her sell order was matched with B's buy order, that would not suffice to show that "her shares" went to B. Settlement between Able and Baker occurs on a net basis for all trades in XYZ

that day; indeed Able's net position may have been such that it received rather than delivered shares in XYZ through the settlement system.

In the unlikely event that this was the only trade in XYZ common stock executed in the market that day, one could follow the shares from S's account to B's account. The plaintiff in an action in conversion or similar legal action to enforce a property interest must show that the defendant has an item of property that belongs to the plaintiff. In this example, B's [security entitlement](#) is not the same item of property that formerly was held by S, it is a new package of rights that B acquired against Baker under Section [8-501](#). Principles of equitable remedies might, however, provide S with a basis for contending that if the position B received was the traceable product of the wrongful taking of S's property by S's twin, a constructive trust should be imposed on B's property in favor of S. See G. Palmer, *The Law of Restitution* § 2.14. Section 8-502 ensures that no such claims can be asserted against a person, such as B in this example, who acquires a security entitlement under Section [8-501](#) for value and without notice, regardless of what theory of law or equity is used to describe the basis of the assertion of the adverse claim.

In the above example, S would ordinarily have no reason to pursue B unless Able is insolvent and S's claim will not be satisfied in the insolvency proceedings. Because S did not give an [entitlement order](#) for the disposition of her security entitlement, Able must recredit her account for the 1000 shares of XYZ common stock. See Section [8-507\(b\)](#).

3. The following examples illustrate the operation of Section 8-502.

Example 1. Thief steals bearer bonds from Owner. Thief delivers the bonds to [Broker](#) for credit to Thief's [securities account](#), thereby acquiring a [security entitlement](#) under Section [8-501\(b\)](#). Under other law, Owner may have a claim to have a constructive trust imposed on the security entitlement as the traceable product of the bonds that Thief misappropriated. Because Thief was himself the wrongdoer, Thief obviously had [notice of Owner's adverse claim](#). Accordingly, Section 8-502 does not preclude Owner from asserting an adverse claim against Thief.

Example 2. Thief steals bearer bonds from Owner. Thief owes a personal debt to Creditor. Creditor has a securities account with Broker. Thief agrees to transfer the bonds to Creditor as security for or in satisfaction of his debt to Creditor. Thief does so by sending the bonds to Broker for credit to Creditor's securities account. Creditor thereby acquires a [security entitlement](#) under Section [8-501\(b\)](#). Under other law, Owner may have a claim to have a constructive trust imposed on the security entitlement as the traceable product of the bonds that Thief misappropriated. Creditor acquired the security entitlement for value, since Creditor acquired it as security for or in satisfaction of Thief's debt to Creditor. See Section [1-201\(44\)](#). If Creditor did not have notice of Owner's claim, Section 8-502 precludes any action by Owner against Creditor, whether framed in constructive trust or other theory. Section [8-105](#) specifies what counts as notice of an adverse claim.

Example 3. Father, as trustee for Son, holds XYZ Co. shares in a securities account with Able & Co. In violation of his fiduciary duties, Father sells the XYZ

Co. shares and uses the proceeds for personal purposes. Father dies, and his estate is insolvent. Assume -- implausibly -- that Son is able to trace the XYZ Co. shares and show that the "same shares" ended up in Buyer's securities account with Baker & Co. Section 8-502 precludes any action by Son against Buyer, whether framed in constructive trust or other theory, provided that Buyer acquired the security entitlement for value and without notice of adverse claims.

Example 4. Debtor holds XYZ Co. shares in a [securities account](#) with Able & Co. As collateral for a loan from Bank, Debtor grants Bank a security interest in the [security entitlement](#) to the XYZ Co. shares. Bank perfects by a method which leaves Debtor with the ability to dispose of the shares. See Section [9-312](#). In violation of the security agreement, Debtor sells the XYZ Co. shares and absconds with the proceeds. Assume -- implausibly -- that Bank is able to trace the XYZ Co. shares and show that the "same shares" ended up in Buyer's securities account with Baker & Co. Section 8-502 precludes any action by Bank against Buyer, whether framed in constructive trust or other theory, provided that Buyer acquired the security entitlement for value and without notice of adverse claims.

Example 5. Debtor owns controlling interests in various public companies, including Acme and Ajax. Acme owns 60% of the stock of another public company, Beta. Debtor causes the Beta stock to be pledged to Lending Bank as collateral for Ajax's debt. Acme holds the Beta stock through an account with a securities custodian, C Bank, which in turn holds through Clearing Corporation. Lending Bank is also a Clearing Corporation participant. The pledge of the Beta stock is implemented by Acme instructing C Bank to instruct Clearing Corporation to debit C Bank's account and credit Lending Bank's account. Acme and Ajax both become insolvent. The Beta stock is still valuable. Acme's liquidator asserts that the pledge of the Beta stock for Ajax's debt was wrongful as against Acme and seeks to recover the Beta stock from Lending Bank. Because the pledge was implemented by an outright transfer into Lending Bank's account at Clearing Corporation, Lending Bank acquired a [security entitlement](#) to the Beta stock under Section [8-501](#). Lending Bank acquired the security entitlement for value, since it acquired it as security for a debt. See Section [1-201\(44\)](#). If Lending Bank did not have notice of Acme's claim, Section 8-502 will preclude any action by Acme against Lending Bank, whether framed in constructive trust or other theory.

Example 6. Debtor grants Alpha Co. a security interest in a [security entitlement](#) that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Alpha also has an account with Able. Debtor instructs Able to transfer the shares to Alpha, and Able does so by crediting the shares to Alpha's account. Alpha has control of the 1000 shares under Section [8-106\(d\)](#). (The facts to this point are identical to those in Section [8-106](#), Comment 4, Example 1, except that Alpha Co. was Alpha Bank.) Alpha next grants Beta Co. a security interest in the 1000 shares included in Alpha's security entitlement. See Section [9-207\(c\)\(3\)](#). Alpha instructs Able to transfer the shares to Gamma Co., Beta's custodian. Able does so, and Gamma credits the 1000 shares to Beta's account. Beta now has control under Section 8-106(d). If the transaction took place with Debtor's permission, Debtor has no adverse claim to assert against Beta, assuming implausibly that Debtor could "trace" an interest to the Gamma account. Moreover, even. if Debtor did hold an adverse claim, if Beta did not

have notice of Debtor's claim, Section 8-502 will preclude any action by Debtor against Beta, whether framed in constructive trust or other theory.

4. Although this section protects [entitlement holders](#) against adverse claims, it does not protect them against the risk that their [securities intermediary](#) will not itself have sufficient [financial assets](#) to satisfy the claims of all of its entitlement holders. Suppose that Customer A holds 1000 shares of XYZ Co. stock in an account with her [broker](#), Able & Co. Able in turn holds 1000 shares of XYZ Co. through its account with Clearing Corporation, but has no other positions in XYZ Co. shares, either for other customers or for its own proprietary account. Customer B places an order with Able for the purchase of 1000 shares of XYZ Co. stock, and pays the purchase price. Able credits B's account with a 1000 share position in XYZ Co. stock, but Able does not itself buy any additional XYZ Co. shares. Able fails, having only 1000 shares to satisfy the claims of A and B. Unless other insolvency law establishes a different distributional rule, A and B would share the 1000 shares held by Able pro rata, without regard to the time that their respective entitlements were established. See Section [8-503\(b\)](#). Section 8-502 protects entitlement holders, such as A and B, against adverse claimants. In this case, however, the problem that A and B face is not that someone is trying to take away their entitlements, but that the entitlements are not worth what they thought. The only role that Section 8-502 plays in this case is to preclude any assertion that A has some form of claim against B by virtue of the fact that Able's establishment of an entitlement in favor of B diluted A's rights to the limited assets held by Able.

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Notice of adverse claim" § [8-105](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Value" § [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-503](#)

1. This section specifies the sense in which a [security entitlement](#) is an interest in the property held by the [securities intermediary](#). It expresses the ordinary understanding that securities that a firm holds for its customers are not general assets of the firm subject to the claims of creditors. Since securities intermediaries generally do not segregate securities in such fashion that one could identify particular securities as the ones held for customers, it would not be realistic for this section to state that "customers' securities" are not subject to creditors' claims. Rather subsection (a) provides that to the extent necessary to satisfy all customer claims, all units of that security held by the firm are held for the [entitlement holders](#), are not property of the securities intermediary, and are not subject to creditors' claims, except as otherwise provided in Section [8-511](#).

An entitlement holder's property interest under this section is an interest with respect to a specific issue of securities or [financial assets](#). For example, customers of a firm who have positions in XYZ common stock have security entitlements with respect to the XYZ common stock held by the intermediary, while other customers who have positions in ABC common stock have security entitlements with respect to the ABC common stock held by the intermediary.

Subsection (b) makes clear that the property interest described in subsection (a) is an interest held in common by all [entitlement holders](#) who have entitlements to a particular [security](#) or other [financial asset](#). Temporal factors are irrelevant. One entitlement holder cannot claim that its rights to the assets held by the intermediary are superior to the rights of another entitlement holder by virtue of having acquired those rights before, or after, the other entitlement holder. Nor does it matter whether the intermediary had sufficient assets to satisfy all entitlement holders' claims at one point, but no longer does. Rather, all entitlement holders have a pro rata interest in whatever positions in that financial asset the intermediary holds.

Although this section describes the property interest of [entitlement holders](#) in the assets held by the intermediary, it does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings. If the intermediary fails and its affairs are being administered in an insolvency proceeding, the applicable insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules for stockbroker liquidation proceedings under the Bankruptcy Code and Securities Investor Protection Act ("SIPA") provide that all customer property is distributed pro rata among all customers in proportion to the dollar value of their total positions, rather than dividing the property on an issue by issue basis. For intermediaries that are not subject to the Bankruptcy Code and SIPA, other insolvency law would determine what distributional rule is applied.

2. Although this section recognizes that the [entitlement holders](#) of a [securities intermediary](#) have a property interest in the [financial assets](#) held by the intermediary, the incidents of this property interest are established by the rules of Article 8, not by common law property concepts. The traditional Article 8 rules on [certificated securities](#) were based on the idea that a paper certificate could be regarded as a nearly complete reification of the underlying right. The rules on transfer and the consequences of wrongful transfer could then be written using the same basic concepts as the rules for physical chattels. A person's claim of ownership of a certificated security is a right to a specific identifiable physical object, and that right can be asserted against any person who ends up in possession of that physical certificate, unless cut off by the rules protecting purchasers for value without notice. Those concepts do not work for the indirect holding system. A [security entitlement](#) is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and the property held by the intermediary. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system. The fundamental principles of the indirect holding system rules are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the [financial asset](#), and that the entitlement holder can look only to that

intermediary for performance of the obligations. The entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom the intermediary holds the positions, or third parties to whom the intermediary may have wrongfully transferred interests, except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing. Subsections (c) through (e) reflect these fundamental principles.

Subsection (c) provides that an [entitlement holder's](#) property interest can be enforced against the intermediary only by exercise of the entitlement holder's rights under Sections [8-505 through 8-508](#). These are the provisions that set out the duty of an intermediary to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the [security](#). If the intermediary is in insolvency proceedings and can no longer perform in accordance with the ordinary Part 5 rules, the applicable insolvency law will determine how the intermediary's assets are to be distributed.

Subsections (d) and (e) specify the limited circumstances in which an [entitlement holder's](#) property interest can be asserted against a third person to whom the intermediary transferred a [financial asset](#) that was subject to the entitlement holder's claim when held by the intermediary. Subsection (d) provides that the property interest of entitlement holders cannot be asserted against any transferee except in the circumstances therein specified. So long as the intermediary is solvent, the entitlement holders must look to the intermediary to satisfy their claims. If the intermediary does not hold financial assets corresponding to the entitlement holders' claims, the intermediary has the duty to acquire them. See Section [8-504](#). Thus, paragraphs (1), (2), and (3) of subsection (d) specify that the only occasion in which the entitlement holders can pursue transferees is when the intermediary is unable to perform its obligation, and the transfer to the transferee was a violation of those obligations. Even in that case, a transferee who gave value and obtained control is protected by virtue of the rule in subsection (e), unless the transferee acted in collusion with the intermediary.

Subsections (d) and (e) have the effect of protecting transferees from an intermediary against adverse claims arising out of assertions by the intermediary's [entitlement holders](#) that the intermediary acted wrongfully in transferring the [financial assets](#). These rules, however, operate in a slightly different fashion than traditional adverse claim cut-off rules. Rather than specifying that a certain class of transferee takes free from all claims, subsections (d) and (e) specify the circumstances in which this particular form of claim can be asserted against a transferee. Revised Article 8 also contains general adverse claim cut-off rules for the indirect holding system. See Sections [8-502](#) and [8-510](#). The rule of subsections (d) and (e) takes precedence over the general cut-off rules of those sections, because Section 8-503 itself defines and sets limits on the assertion of the property interest of entitlement holders. Thus, the question whether entitlement holders' property interest can be asserted as an adverse claim against a transferee from the intermediary is governed by the collusion test of Section 8-503(e), rather than by the "without notice" test of Sections [8-502](#) and [8-510](#).

3. The limitations that subsections (c) through (e) place on the ability of customers of a failed intermediary to recover [securities](#) or other [financial assets](#)

from transferees are consistent with the fundamental policies of investor protection that underlie this Article and other bodies of law governing the securities business. The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than from the *post hoc* perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. Although one can devise hypothetical scenarios where particular customers might find it advantageous to be able to assert rights against someone other than the customers' own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system. Suppose, for example, that Intermediary A transfers securities to B, that Intermediary A acted wrongfully as against its customers in so doing, and that after the transaction Intermediary A did not have sufficient securities to satisfy its obligations to its [entitlement holders](#). Viewed solely from the standpoint of the customers of Intermediary A, it would seem that permitting the property to be recovered from B, would be good for investors. That, however, is not the case. B may itself be an intermediary with its own customers, or may be some other institution through which individuals invest, such as a pension fund or investment company. There is no reason to think that rules permitting customers of an intermediary to trace and recover securities that their intermediary wrongfully transferred work to the advantage of investors in general. To the contrary, application of such rules would often merely shift losses from one set of investors to another. The uncertainties that would result from rules permitting such recoveries would work to the disadvantage of all participants in the securities markets.

The use of the collusion test in Section 8-503(e) furthers the interests of investors generally in the sound and efficient operation of the securities holding and settlement system. The effect of the choice of this standard is that customers of a failed intermediary must show that the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct, rather than casting on the transferee any burden of showing that the transferee had no awareness of wrongful conduct by the failed intermediary. The rule of Section 8-503(e) is based on the long-standing policy that it is undesirable to impose upon purchasers of [securities](#) any duty to investigate whether their sellers may be acting wrongfully.

Rather than imposing duties to investigate, the general policy of the commercial law of the securities holding and transfer system has been to eliminate legal rules that might induce participants to conduct investigations of the authority of persons transferring securities on behalf of others for fear that they might be held liable for participating in a wrongful transfer. The rules in Part 4 of Article 8 concerning transfers by fiduciaries provide a good example. Under *Lowry v. Commercial & Farmers' Bank*, 15 F. Cas. 1040 (C.C.D. Md. 1848) (No. 8551), an [issuer](#) could be held liable for wrongful transfer if it registered transfer of securities by a fiduciary under circumstances where it had any reason to believe that the fiduciary may have been acting improperly. In one sense that seems to be advantageous for beneficiaries who might be harmed by wrongful conduct by fiduciaries. The consequence of the *Lowry* rule, however, was that in order to protect against risk of such liability, issuers developed the practice of requiring

extensive documentation for fiduciary stock transfers, making such transfers cumbersome and time consuming. Accordingly, the rules in Part 4 of Article 8, and in the prior fiduciary transfer statutes, were designed to discourage transfer agents from conducting investigations into the rightfulness of transfers by fiduciaries.

The rules of Revised Article 8 implement for the indirect holding system the same policies that the rules on [protected purchasers](#) and registration of transfer adopt for the direct holding system. A [securities intermediary](#) is, by definition, a person who is holding securities on behalf of other persons. There is nothing unusual or suspicious about a transaction in which a securities intermediary sells securities that it was holding for its customers. That is exactly what securities intermediaries are in business to do. The interests of customers of securities intermediaries would not be served by a rule that required counterparties to transfers from securities intermediaries to investigate whether the intermediary was acting wrongfully against its customers. Quite the contrary, such a rule would impair the ability of securities intermediaries to perform the function that customers want.

The rules of Section 8-503(c) through (e) apply to transferees generally, including pledgees. The reasons for treating pledgees in the same fashion as other transferees are discussed in the Comments to Section [8-511](#). The statement in subsection (a) that an intermediary holds [financial assets](#) for customers and not as its own property does not, of course, mean that the intermediary lacks power to transfer the financial assets to others. For example, although Article 9 provides that for a security interest to attach the debtor must either have "rights" in the collateral or the power to transfer "rights" in the collateral to a secured party, see Section [9-203](#), the fact that an intermediary is holding a financial asset in a form that permits ready transfer means that it has such rights, even if the intermediary is acting wrongfully against its [entitlement holders](#) in granting the security interest. The question whether the secured party takes subject to the entitlement holder's claim in such a case is governed by Section [8-511](#), which is an application to secured transactions of the general principles expressed in subsections (d) and (e) of this section.

Definitional Cross References

"Control" § [8-106](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Insolvency proceedings" § [1-201\(22\)](#)

"Purchaser" § [1-201\(33\)](#) & [8-116](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Value" §§ [1-201\(44\)](#) & [8-116](#)

Official Comment [§ 8-504](#)

1. This section expresses one of the core elements of the relationships for which the Part 5 rules were designed, to wit, that a [securities intermediary](#) undertakes to hold [financial assets](#) corresponding to the security entitlements of its [entitlement holders](#). The locution "shall promptly obtain and shall thereafter maintain" is taken from the corresponding regulation under federal securities law, 17 C.F.R. § 240.15c3-3. This section recognizes the reality that as the securities business is conducted today, it is not possible to identify particular securities as belonging to customers as distinguished from other particular securities that are the firm's own property. Securities firms typically keep all securities in fungible form, and may maintain their inventory of a particular security in various locations and forms, including physical securities held in vaults or in transit to transfer agents, and book entry positions at one or more clearing corporations. Accordingly, this section states that a securities intermediary shall maintain a quantity of financial assets corresponding to the aggregate of all security entitlements it has established. The last sentence of subsection (a) provides explicitly that the securities intermediary may hold directly or indirectly. That point is implicit in the use of the term "[financial asset](#)," inasmuch as Section [8-102\(a\)\(9\)](#) provides that the term "financial asset" may refer either to the underlying asset or the means by which it is held, including both [security certificates](#) and security entitlements.

2. Subsection (b) states explicitly a point that is implicit in the notion that a [securities intermediary](#) must maintain [financial assets](#) corresponding to the security entitlements of its [entitlement holders](#), to wit, that it is wrongful for a securities intermediary to grant security interests in positions that it needs to satisfy customers' claims, except as authorized by the customers. This statement does not determine the rights of a secured party to whom a securities intermediary wrongfully grants a security interest; that issue is governed by Sections [8-503](#) and [8-511](#).

Margin accounts are common examples of arrangements in which an [entitlement holder](#) authorizes the securities intermediary to grant security interests in the positions held for the entitlement holder. Securities firms commonly obtain the funds needed to provide margin loans to their customers by "rehypothecating" the customers' securities. In order to facilitate rehypothecation, agreements between margin customers and their brokers commonly authorize the [broker](#) to commingle securities of all margin customers for rehypothecation to the lender who provides the financing. Brokers commonly rehypothecate customer securities having a value somewhat greater than the amount of the loan made to the customer, since the lenders who provide the necessary financing to the broker need some cushion of protection against the risk of decline in the value of the rehypothecated securities. The extent and manner in which a firm may rehypothecate customers' securities are determined by the agreement between the intermediary and the entitlement holder and by applicable regulatory law. Current regulations under the federal securities laws require that brokers obtain the explicit consent of customers before pledging customer securities or commingling different customers' securities for pledge. Federal regulations also

limit the extent to which a broker may rehypothecate customer securities to 110% of the aggregate amount of the borrowings of all customers.

3. The statement in this section that an intermediary must obtain and maintain [financial assets](#) corresponding to the aggregate of all security entitlements it has established is intended only to capture the general point that one of the key elements that distinguishes securities accounts from other relationships, such as deposit accounts, is that the intermediary undertakes to maintain a direct correspondence between the positions it holds and the claims of its customers. This section is not intended as a detailed specification of precisely how the intermediary is to perform this duty, nor whether there may be special circumstances in which an intermediary's general duty is excused. Accordingly, the general statement of the duties of a [securities intermediary](#) in this and the following sections is supplemented by two other provisions. First, each of Sections [8-504 through 8-508](#) contains an "agreement/due care" provision. Second, Section [8-509](#) sets out general qualifications on the duties stated in these sections, including the important point that compliance with corresponding regulatory provisions constitutes compliance with the Article 8 duties.

4. The "agreement/due care" provision in subsection (c) of this section is necessary to provide sufficient flexibility to accommodate the general duty stated in subsection (a) to the wide variety of circumstances that may be encountered in the modern securities holding system. For the most common forms of publicly traded securities, the modern depository-based indirect holding system has made the likelihood of an actual loss of securities remote, though correctable errors in accounting or temporary interruptions of data processing facilities may occur. Indeed, one of the reasons for the evolution of book-entry systems is to eliminate the risk of loss or destruction of physical certificates. There are, however, some forms of securities and other [financial assets](#) which must still be held in physical certificated form, with the attendant risk of loss or destruction. Risk of loss or delay may be a more significant consideration in connection with foreign securities. An American securities intermediary may well be willing to hold a foreign security in a [securities account](#) for its customer, but the intermediary may have relatively little choice of or control over foreign intermediaries through which the security must in turn be held. Accordingly, it is common for American securities intermediaries to disclaim responsibility for custodial risk of holding through foreign intermediaries.

Subsection (c)(1) provides that a [securities intermediary](#) satisfies the duty stated in subsection (a) if the intermediary acts with respect to that duty in accordance with the agreement between the intermediary and the [entitlement holder](#). Subsection (c)(2) provides that if there is no agreement on the matter, the intermediary satisfies the subsection (a) duty if the intermediary exercises due care in accordance with reasonable commercial standards to obtain and maintain the [financial asset](#) in question. This formulation does not state that the intermediary has a universally applicable statutory duty of due care. Section [1-102\(3\)](#) provides that statutory duties of due care cannot be disclaimed by agreement, but the "agreement/due care" formula contemplates that there may be particular circumstances where the parties do not wish to create a specific duty of due care, for example, with respect to foreign securities. Under subsection (c)(1), compliance with the agreement constitutes satisfaction of the

subsection (a) duty, whether or not the agreement provides that the intermediary will exercise due care.

In each of the sections where the "agreement/due care" formula is used, it provides that entering into an agreement and performing in accordance with that agreement is a method by which the [securities intermediary](#) may satisfy the statutory duty stated in that section. Accordingly, the general obligation of [good faith](#) performance of statutory and contract duties, see Sections [1-203](#) and [8-102\(a\)](#)(10), would apply to such an agreement. It would not be consistent with the obligation of good faith performance for an agreement to purport to establish the usual sort of arrangement between an intermediary and [entitlement holder](#), yet disclaim altogether one of the basic elements that define that relationship. For example, an agreement stating that an intermediary assumes no responsibilities whatsoever for the safekeeping any of the entitlement holder's securities positions would not be consistent with good faith performance of the intermediary's duty to obtain and maintain [financial assets](#) corresponding to the entitlement holder's security entitlements.

To the extent that no agreement under subsection (c)(1) has specified the details of the intermediary's performance of the subsection (a) duty, subsection (c)(2) provides that the intermediary satisfies that duty if it exercises due care in accordance with reasonable commercial standards. The duty of care includes both care in the intermediary's own operations and care in the selection of other intermediaries through whom the intermediary holds the assets in question. The statement of the obligation of due care is meant to incorporate the principles of the common law under which the specific actions or precautions necessary to meet the obligation of care are determined by such factors as the nature and value of the property, the customs and practices of the business, and the like.

5. This section necessarily states the duty of a [securities intermediary](#) to obtain and maintain [financial assets](#) only at the very general and abstract level. For the most part, these matters are specified in great detail by regulatory law. Broker-dealers registered under the federal securities laws are subject to detailed regulation concerning the safeguarding of customer securities. See 17 C.F.R. § 240.15c3-3. Section [8-509\(a\)](#) provides explicitly that if a securities intermediary complies with such regulatory law, that constitutes compliance with Section 8-504. In certain circumstances, these rules permit a firm to be in a position where it temporarily lacks a sufficient quantity of financial assets to satisfy all customer claims. For example, if another firm has failed to make a [delivery](#) to the firm in settlement of a trade, the firm is permitted a certain period of time to clear up the problem before it is obligated to obtain the necessary securities from some other source.

6. Subsection (d) is intended to recognize that there are some circumstances, where the duty to maintain a sufficient quantity of [financial assets](#) does not apply because the intermediary is not holding anything on behalf of others. For example, the Options Clearing Corporation is treated as a "[securities intermediary](#)" under this Article, although it does not itself hold options on behalf of its participants. Rather, it becomes the issuer of the options, by virtue of guaranteeing the obligations of participants in the [clearing corporation](#) who have written or purchased the options cleared through it. See Section [8-103\(e\)](#). Accordingly, the general duty of an intermediary under subsection (a) does not

apply, nor would other provisions of Part 5 that depend upon the existence of a requirement that the securities intermediary hold financial assets, such as Sections [8-503](#) and [8-508](#).

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Clearing corporation" § [8-102\(a\)\(5\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

Official Comment [§ 8-505](#)

1. One of the core elements of the [securities account](#) relationships for which the Part 5 rules were designed is that the [securities intermediary](#) passes through to the [entitlement holders](#) the economic benefit of ownership of the [financial asset](#), such as payments and distributions made by the [issuer](#). Subsection (a) expresses the ordinary understanding that a securities intermediary will take appropriate action to see to it that any payments or distributions made by the issuer are received. One of the main reasons that investors make use of securities intermediaries is to obtain the services of a professional in performing the record-keeping and other functions necessary to ensure that payments and other distributions are received.
2. Subsection (a) incorporates the same "agreement/due care" formula as the other provisions of Part 5 dealing with the duties of a [securities intermediary](#). See [4 to Section 8-504](#). This formulation permits the parties to specify by agreement what action, if any, the intermediary is to take with respect to the duty to obtain payments and distributions. In the absence of specification by agreement, the intermediary satisfies the duty if the intermediary exercises due care in accordance with reasonable commercial standards. The provisions of Section [8-509](#) also apply to the Section 8-505 duty, so that compliance with applicable regulatory requirements constitutes compliance with the Section 8-505 duty.
3. Subsection (b) provides that a [securities intermediary](#) is obligated to its [entitlement holder](#) for those payments or distributions made by the [issuer](#) that are in fact received by the intermediary. It does not deal with the details of the time and manner of payment. Moreover, as with any other monetary obligation, the obligation to pay may be subject to other rights of the obligor, by way of set-off counterclaim or the like. Section [8-509\(c\)](#) makes this point explicit.

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

COMMENT [§ 8-506](#)

1. Another of the core elements of the [securities account](#) relationships for which the Part 5 rules were designed is that although the intermediary may, by virtue of the structure of the indirect holding system, be the party who has the power to exercise the corporate and other rights that come from holding the [security](#), the intermediary exercises these powers as representative of the [entitlement holder](#) rather than at its own discretion. This characteristic is one of the things that distinguishes a securities account from other arrangements where one person holds securities "on behalf of" another, such as the relationship between a mutual fund and its shareholders or a trustee and its beneficiary.

2. The fact that the intermediary exercises the rights of security holding as representative of the [entitlement holder](#) does not, of course, preclude the entitlement holder from conferring discretionary authority upon the intermediary. Arrangements are not uncommon in which investors do not wish to have their intermediaries forward proxy materials or other information. Thus, this section provides that the intermediary shall exercise corporate and other rights "if directed to do so" by the entitlement holder. Moreover, as with the other Part 5 duties, the "agreement/due care" formulation is used in stating how the intermediary is to perform this duty. This section also provides that the intermediary satisfies the duty if it places the entitlement holder in a position to exercise the rights directly. This is to take account of the fact that some of the rights attendant upon ownership of the security, such as rights to bring derivative and other litigation, are far removed from the matters that intermediaries are expected to perform.

3. This section, and the two that follow, deal with the aspects of securities holding that are related to investment decisions. For example, one of the rights of holding a particular security that would fall within the purview of this section would be the right to exercise a conversion right for a convertible security. It is quite common for investors to confer discretionary authority upon another person, such as an investment adviser, with respect to these rights and other investment decisions. Because this section, and the other sections of Part 5, all specify that a [securities intermediary](#) satisfies the Part 5 duties if it acts in accordance with the [entitlement holder's](#) agreement, there is no inconsistency between the statement of duties of a securities intermediary and these common arrangements.

4. Section [8-509](#) also applies to the Section 8-506 duty, so that compliance with applicable regulatory requirements constitutes compliance with this duty. This is

quite important in this context, since the federal [securities](#) laws establish a comprehensive system of regulation of the distribution of proxy materials and exercise of voting rights with respect to securities held through brokers and other intermediaries. By virtue of Section [8-509\(a\)](#), compliance with such regulatory requirement constitutes compliance with the Section 8-506 duty.

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

COMMENT [§ 8-507](#)

1. Subsection (a) of this section states another aspect of duties of securities intermediaries that make up security entitlements -- the securities intermediary's duty to comply with [entitlement orders](#). One of the main reasons for holding securities through securities intermediaries is to enable rapid transfer in settlement of trades. Thus the right to have one's orders for disposition of the [security entitlement](#) honored is an inherent part of the relationship. Subsection (b) states the correlative liability of a [securities intermediary](#) for transferring a [financial asset](#) from an entitlement holder's account pursuant to an entitlement order that was not [effective](#).

2. The duty to comply with [entitlement orders](#) is subject to several qualifications. The intermediary has a duty only with respect to an entitlement order that is in fact originated by the [appropriate person](#). Moreover, the intermediary has a duty only if it has had reasonable opportunity to assure itself that the order is genuine and authorized, and reasonable opportunity to comply with the order. The same "agreement/due care" formula is used in this section as in the other Part 5 sections on the duties of intermediaries, and the rules of Section 8-509 apply to the Section 8-507 duty.

3. [Appropriate person](#) is defined in Section [8-107](#). In the usual case, the appropriate person is the [entitlement holder](#), see Section [8-107\(a\)\(3\)](#). Entitlement holder is defined in Section [8-102\(a\)\(7\)](#) as the person "identified in the records of a [securities intermediary](#) as the person having a [security entitlement](#)." Thus, the general rule is that an intermediary's duty with respect to [entitlement orders](#) runs only to the person with whom the intermediary has established a relationship. One of the basic principles of the indirect holding system is that securities intermediaries owe duties only to their own customers. See also Section [8-115](#). The only situation in which a securities intermediary has a duty to comply with entitlement orders originated by a person other than the person with whom the intermediary established a relationship is covered by Section [8-107\(a\)\(4\)](#) and (a)(5), which provide that the term "appropriate person"

includes the successor or personal representative of a decedent, or the custodian or guardian of a person who lacks capacity. If the entitlement holder is competent, another person does not fall within the defined term "appropriate person" merely by virtue of having power to act as an agent for the entitlement holder. Thus, an intermediary is not required to determine at its peril whether a person who purports to be authorized to act for an entitlement holder is in fact authorized to do so. If an entitlement holder wishes to be able to act through agents, the entitlement holder can establish appropriate arrangements in advance with the securities intermediary.

One important application of this principle is that if an [entitlement holder](#) grants a security interest in its security entitlements to a third-party lender, the intermediary owes no duties to the secured party, unless the intermediary has entered into a "control" agreement in which it agrees to act on [entitlement orders](#) originated by the secured party. See Section [8-106](#). Even though the security agreement or some other document may give the secured party authority to act as agent for the debtor, that would not make the secured party an "appropriate person" to whom the security intermediary owes duties. If the entitlement holder and [securities intermediary](#) have agreed to such a control arrangement, then the intermediary's action in following [instructions](#) from the secured party would satisfy the subsection (a) duty. Although an agent, such as the secured party in this example, is not an "appropriate person," an entitlement order is "[effective](#)" if originated by an authorized person. See Section [8-107\(a\)](#) and [\(b\)](#). Moreover, Section 8-507(a) provides that the intermediary satisfies its duty if it acts in accordance with the entitlement holder's agreement.

4. Subsection (b) provides that an intermediary is liable for a wrongful transfer if the [entitlement order](#) was "ineffective." Section [8-107](#) specifies whether an entitlement order is effective. An "effective entitlement order" is different from an "entitlement order originated by an [appropriate person](#)." An entitlement order is effective under Section [8-107\(b\)](#) if it is made by the appropriate person, or by a person who has power to act for the appropriate person under the law of agency, or if the appropriate person has ratified the entitlement order or is precluded from denying its effectiveness. Thus, although a securities intermediary does not have a duty to act on an entitlement order originated by the [entitlement holder's](#) agent, the intermediary is not liable for wrongful transfer if it does so.

Subsection (b), together with Section [8-107](#), has the effect of leaving to other law most of the questions of the sort dealt with by Article 4A for wire transfers of funds, such as allocation between the securities intermediary and the [entitlement holder](#) of the risk of fraudulent [entitlement orders](#).

5. The term [entitlement order](#) does not cover all directions that a customer might give a [broker](#) concerning [securities](#) held through the broker. Article 8 is not a codification of all of the law of customers and stockbrokers. Article 8 deals with the settlement of securities trades, not the trades. The term entitlement order does not refer to [instructions](#) to a broker to make trades, that is, enter into contracts for the purchase or sale of securities. Rather, the entitlement order is the mechanism of transfer for securities held through intermediaries, just as indorsements and instructions are the mechanism for securities held directly. In the ordinary case the customer's direction to the broker to deliver the securities

at settlement is implicit in the customer's instruction to the broker to sell. The distinction is, however, significant in that this section has no application to the relationship between the customer and broker with respect to the trade itself. For example, assertions by a customer that it was damaged by a broker's failure to execute a trading order sufficiently rapidly or in the proper manner are not governed by this Article.

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Appropriate person" § [8-107](#)

"Effective" § [8-107](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Entitlement order" § [8-102\(a\)\(8\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

COMMENT § [8-508](#)

1. This section states another aspect of the duties of securities intermediaries that make up security entitlements -- the obligation of the [securities intermediary](#) to change an [entitlement holder's](#) position into any other form of holding for which the entitlement holder is eligible or to transfer the entitlement holder's position to an account at another intermediary. This section does not state unconditionally that the securities intermediary is obligated to turn over a certificate to the customer or to cause the customer to be registered on the books of the [issuer](#), because the customer may not be eligible to hold the security directly. For example, municipal bonds are now commonly issued in "book-entry only" form, in which the only entity that the issuer will register on its own books is a depository.

If [security certificates](#) in [registered form](#) are issued for the security, and individuals are eligible to have the security registered in their own name, the [entitlement holder](#) can request that the intermediary deliver or cause to be delivered to the entitlement holder a certificate registered in the name of the entitlement holder or a certificate indorsed in blank or specially indorsed to the entitlement holder. If security certificates in bearer form are issued for the security, the entitlement holder can request that the intermediary deliver or cause to be delivered a certificate in bearer form. If the security can be held by individuals directly in uncertificated form, the entitlement holder can request that the security be registered in its name. The specification of this duty does not determine the pricing terms of the agreement in which the duty arises.

2. The same "agreement/due care" formula is used in this section as in the other Part 5 sections on the duties of intermediaries. So too, the rules of Section [8-509](#) apply to the Section 8-508 duty.

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

COMMENT [§ 8-509](#)

This Article is not a comprehensive statement of the law governing the relationship between broker-dealers or other securities intermediaries and their customers. Most of the law governing that relationship is the common law of contract and agency, supplemented or supplanted by regulatory law. This Article deals only with the most basic commercial/property law principles governing the relationship. Although Sections [8-504 through 8-508](#) specify certain duties of securities intermediaries to [entitlement holders](#), the point of these sections is to identify what it means to have a [security entitlement](#), not to specify the details of performance of these duties.

For many intermediaries, regulatory law specifies in great detail the intermediary's obligations on such matters as safekeeping of customer property, distribution of proxy materials, and the like. To avoid any conflict between the general statement of duties in this Article and the specific statement of intermediaries' obligations in such regulatory schemes, subsection (a) provides that compliance with applicable regulation constitutes compliance with the duties specified in Sections [8-504 through 8-508](#).

Definitional Cross References

"Agreement" § [1-201\(3\)](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security agreement" § [9-102\(a\)\(73\)](#)

"Security interest" § [1-201\(37\)](#)

COMMENT [§ 8-510](#)

1. This section specifies certain rules concerning the rights of persons who purchase interests in security entitlements from [entitlement holders](#). The rules of this section are provided to take account of cases where the purchaser's rights are derivative from the rights of another person who is and continues to be the entitlement holder.

2. Subsection (a) provides that no adverse claim can be asserted against a purchaser of an interest in a [security entitlement](#) if the purchaser gives value, obtains control, and does not have [notice of the adverse claim](#). The primary purpose of this rule is to give adverse claim protection to persons who take security interests in security entitlements and obtain control, but do not themselves become [entitlement holders](#).

The following examples illustrate subsection (a):

Example 1. X steals a certificated bearer bond from Owner. X delivers the certificate to Able & Co. for credit to X's [securities account](#). Later, X borrows from Bank and grants bank a security interest in the security entitlement. Bank obtains control under Section [8-106\(d\)\(2\)](#) by virtue of an agreement in which Able agrees to comply with [entitlement orders](#) originated by Bank. X absconds.

Example 2. Same facts as in Example 1, except that Bank does not obtain a control agreement. Instead, Bank perfects by filing a financing statement.

In both of these examples, when X deposited the bonds X acquired a security entitlement under Section [8-501](#). Under other law, Owner may be able to have a constructive trust imposed on the security entitlement as the traceable product of the bonds that X misappropriated. X granted a security interest in that entitlement to Bank. Bank was a purchaser of an interest in the security entitlement from X. In Example 1, although Bank was not a person who acquired a [security entitlement](#) from the intermediary, Bank did obtain control. If Bank did not have notice of Owner's claim, Section 8-510(a) precludes Owner from asserting an adverse claim against Bank. In Example 2, Bank had a perfected security interest, but did not obtain control. Accordingly, Section 8-510(a) does not preclude Owner from asserting its adverse claim against Bank.

3. Subsection (b) applies to the indirect holding system a limited version of the "shelter principle." The following example illustrates the relatively limited class of cases for which it may be needed:

Example 3. Thief steals a certificated bearer bond from Owner. Thief delivers the certificate to Able & Co. for credit to Thief's [securities account](#). Able forwards the certificate to a clearing corporation for credit to Able's account. Later Thief instructs Able to sell the positions in the bonds. Able sells to Baker & Co., acting as [broker](#) for Buyer. The trade is settled by book-entries in the accounts of Able and Baker at the clearing corporation, and in the accounts of Thief and Buyer at Able and Baker respectively. Owner may be able to reconstruct the trade records to show that settlement occurred in such fashion that the "same bonds" that were carried in Thief's account at Able are traceable into Buyer's account at Baker. Buyer later decides to donate the bonds to Alma Mater University and executes an assignment of its rights as [entitlement holder](#) to Alma Mater.

Buyer had a position in the bonds, which Buyer held in the form of a security entitlement against Baker. Buyer then made a gift of the position to Alma Mater. Although Alma Mater is a purchaser, Section [1-201\(33\)](#), it did not give value. Thus, Alma Mater is a person who purchased a security entitlement, or an interest therein, from an entitlement holder (Buyer). Buyer was protected against Owner's adverse claim by the Section [8-502](#) rule. Thus, by virtue of Section 8-510(b), Owner is also precluded from asserting an adverse claim against Alma Mater.

4. Subsection (c) specifies a priority rule for cases where an [entitlement holder](#) transfers conflicting interests in the same [security entitlement](#) to different purchasers. It follows the same principle as the Article 9 priority rule for investment property, that is, control trumps non-control. Indeed, the most significant category of conflicting "purchasers" may be secured parties. Priority questions for security interests, however, are governed by the rules in Article 9. Subsection (c) applies only to cases not covered by the Article 9 rules. It is intended primarily for disputes over conflicting claims arising out of repurchase agreement transactions that are not covered by the other rules set out in Articles 8 and 9.

The following example illustrates subsection (c):

Example 4. Dealer holds [securities](#) through an account at Alpha Bank. Alpha Bank in turn holds through a [clearing corporation](#) account. Dealer transfers securities to RP1 in a "hold in custody" repo transaction. Dealer then transfers the same securities to RP2 in another repo transaction. The repo to RP2 is implemented by transferring the securities from Dealer's regular account at Alpha Bank to a special account maintained by Alpha Bank for Dealer and RP2. The agreement among Dealer, RP2, and Alpha Bank provides that Dealer can make substitutions for the securities but RP2 can direct Alpha Bank to sell any securities held in the special account. Dealer becomes insolvent. RP1 claims a prior interest in the securities transferred to RP2.

In this example Dealer remained the [entitlement holder](#) but agreed that RP2 could initiate [entitlement orders](#) to Dealer's security intermediary, Alpha Bank. If RP2 had become the entitlement holder, the adverse claim rule of Section [8-502](#) would apply. Even if RP2 does not become the entitlement holder, the arrangement among Dealer, Alpha Bank, and RP2 does suffice to give RP2 control. Thus, under Section 8-510(c), RP2 has priority over RP1, because RP2 is a purchaser who obtained control, and RP1 is a purchaser who did not obtain control. The same result could be reached under Section 8-510(a) which provides that RP1's earlier in time interest cannot be asserted as an adverse claim against RP2. The same result would follow under the Article 9 priority rules if the interests of RP1 and RP2 are characterized as "security interests," see Section [9-115\(5\)](#)(a). The main point of the rules of Section 8-510(c) is to ensure that there will be clear rules to cover the conflicting claims of RP1 and RP2 without characterizing their interests as Article 9 security interests.

The priority rules in Article 9 for conflicting security interests also include a default rule of pro rata treatment for cases where multiple secured parties have obtained control but omitted to specify their respective rights by agreement. See Section [9-115\(5\)](#)(b) and Comment 6 to Section 9-115. Because the purchaser

priority rule in Section 8-510(c) is intended to track the Article 9 priority rules, it too has a pro rata rule for cases where multiple non-secured party purchasers have obtained control but omitted to specify their respective rights by agreement.

Definitional Cross References

"Adverse claim" § [8-102\(a\)\(1\)](#)

"Control" § [8-106](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Notice of adverse claim" § [8-105](#)

"Purchase" § [1-201\(32\)](#)

"Purchaser" §§ [1-201\(33\)](#) & [8-116](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Value" §§ [1-201\(44\)](#) & [8-116](#)

COMMENT [§ 8-511](#)

1. This section sets out priority rules for circumstances in which a [securities intermediary](#) fails leaving an insufficient quantity of securities or other [financial assets](#) to satisfy the claims of its [entitlement holders](#) and the claims of creditors to whom it has granted security interests in financial assets held by it. Subsection (a) provides that entitlement holders' claims have priority except as otherwise provided in subsection (b), and subsection (b) provides that the secured creditor's claim has priority if the secured creditor obtains control, as defined in Section [8-106](#). The following examples illustrate the operation of these rules.

Example 1. Able & Co., a [broker](#), borrows from Alpha Bank and grants Alpha Bank a security interest pursuant to a written agreement which identifies certain securities that are to be collateral for the loan, either specifically or by category. Able holds these securities in a [clearing corporation](#) account. Able becomes insolvent and it is discovered that Able holds insufficient securities to satisfy the claims of customers who have paid for securities that they held in accounts with Able and the collateral claims of Alpha Bank. Alpha Bank's security interest in the security entitlements that Able holds through the clearing corporation account may be perfected under the automatic perfection rule of Section [9-309\(10\)](#), but Alpha Bank did not obtain control under Section [8-106](#). Thus, under Section 8-511(a) the [entitlement holders'](#) claims have priority over Alpha Bank's claim.

Example 2. Able & Co., a [broker](#), borrows from Beta Bank and grants Beta Bank a security interest in [securities](#) that Able holds in a [clearing corporation](#) account. Pursuant to the security agreement, the securities are debited from Alpha's account and credited to Beta's account in the clearing corporation account. Able becomes insolvent and it is discovered that Able holds insufficient securities to satisfy the claims of customers who have paid for securities that they held in accounts with Able and the collateral claims of Alpha Bank. Although the transaction between Able and Beta took the form of an outright transfer on the clearing corporation's books, as between Able and Beta, Able remains the owner and Beta has a security interest. In that respect the situation is no different than if Able had delivered bearer bonds to Beta in pledge to secure a loan. Beta's security interest is perfected, and Beta obtained control. See Sections [8-106](#) and [9-314](#). Under Section 8-511(b), Beta Bank's security interest has priority over claims of Able's customers.

The result in Example 2 is an application to this particular setting of the general principle expressed in Section [8-503](#), and explained in the Comments thereto, that the [entitlement holders](#) of a [securities intermediary](#) cannot assert rights against third parties to whom the intermediary has wrongfully transferred interests, except in extremely unusual circumstances where the third party was itself a participant in the transferor's wrongdoing. Under subsection (b) the claim of a secured creditor of a securities intermediary has priority over the claims of entitlement holders if the secured creditor has obtained control. If, however, the secured creditor acted in collusion with the intermediary in violating the intermediary's obligation to its entitlement holders, then under Section [8-503\(e\)](#), the entitlement holders, through their representative in insolvency proceedings, could recover the interest from the secured creditor, that is, set aside the security interest.

2. The risk that investors who hold through an intermediary will suffer a loss as a result of a wrongful pledge by the intermediary is no different than the risk that the intermediary might fail and not have the securities that it was supposed to be holding on behalf of its customers, either because the securities were never acquired by the intermediary or because the intermediary wrongfully sold securities that should have been kept to satisfy customers' claims. Investors are protected against that risk by the regulatory regimes under which securities intermediaries operate. Intermediaries are required to maintain custody, through [clearing corporation](#) accounts or in other approved locations, of their customers' securities and are prohibited from using customers' securities in their own business activities. Securities firms who are carrying both customer and proprietary positions are not permitted to grant blanket liens to lenders covering all securities which they hold, for their own account or for their customers. Rather, securities firms designate specifically which positions they are pledging. Under SEC Rules 8c-1 and 15c2-1, customers' securities can be pledged only to fund loans to customers, and only with the consent of the customers. Customers' securities cannot be pledged for loans for the firm's proprietary business; only proprietary positions can be pledged for proprietary loans. SEC Rule 15c3-3 implements these prohibitions in a fashion tailored to modern securities firm accounting systems by requiring brokers to maintain a sufficient inventory of securities, free from any liens, to satisfy the claims of all of their customers for fully paid and excess margin securities. Revised Article 8 mirrors that requirement, specifying in Section [8-504](#) that a [securities intermediary](#) must maintain a sufficient quantity of investment property to satisfy all security

entitlements, and may not grant security interests in the positions it is required to hold for customers, except as authorized by the customers.

If a failed brokerage has violated the customer protection regulations and does not have sufficient securities to satisfy customers' claims, its customers are protected against loss from a shortfall by the Securities Investor Protection Act ("SIPA"). Securities firms required to register as brokers or dealers are also required to become members of the Securities Investor Protection Corporation ("SIPC"), which provides their customers with protection somewhat similar to that provided by FDIC and other deposit insurance programs for bank depositors. When a member firm fails, SIPC is authorized to initiate a liquidation proceeding under the provisions of SIPA. If the assets of the securities firm are insufficient to satisfy all customer claims, SIPA makes contributions to the estate from a fund financed by assessments on its members to protect customers against losses up to \$500,000 for cash and securities held at member firms.

Article 8 is premised on the view that the important policy of protecting investors against the risk of wrongful conduct by their intermediaries is sufficiently treated by other law.

3. Subsection (c) sets out a special rule for secured financing provided to enable [clearing corporations](#) to complete settlement. In order to permit clearing corporations to establish liquidity facilities where necessary to ensure completion of settlement, subsection (c) provides a priority for secured lenders to such clearing corporations. Subsection (c) does not turn on control because the clearing corporation may be the top tier [securities intermediary](#) for the securities pledged, so that there may be no practicable method for conferring control on the lender.

Definitional Cross References

"Clearing corporation" § [8-102\(a\)\(5\)](#)

"Control" § [8-106](#)

"Entitlement holder" § [8-102\(a\)\(7\)](#)

"Financial asset" § [8-102\(a\)\(9\)](#)

"Securities intermediary" § [8-102\(a\)\(14\)](#)

"Security entitlement" § [8-102\(a\)\(17\)](#)

"Security interest" § [1-201\(37\)](#)

"Value" §§ [1-201\(44\)](#) & [8-116](#)

COMMENT [§ 8-602](#)

If the State has adopted the Uniform Act for the Simplification of Fiduciary Security Transfers, or similar legislation, it should be repealed.

COMMENT [§ 8-603](#)

The revision of Article 8 should present few significant transition problems. Although the revision involves significant changes in terminology and analysis, the substantive rules are, in large measure, based upon the current practices and are consistent with results that could be reached, albeit at times with some struggle, by proper interpretation of the rules of present law. Thus, the new rules can be applied, without significant dislocations, to transactions and events that occurred prior to enactment.

The enacting provisions should not, whether by applicability, transition, or savings clause language, attempt to provide that old Article 8 continues to apply to "transactions," "events," "rights," "duties," "liabilities," or the like that occurred or accrued before the effective date and that new Article 8 applies to those that occur or accrue after the effective date. The reason for revising Article 8 and corresponding provisions of Article 9 is the concern that the provisions of old Article 8 could be interpreted or misinterpreted to yield results that impede the safe and efficient operation of the national system for the clearance and settlement of securities transactions. Accordingly, it is not the case that any effort should be made to preserve the applicability of old Article 8 to transactions and events that occurred before the effective date.

Only two circumstances seem to warrant continued application of rules of old Article 8. First, to avoid disruption in the conduct of litigation, it may make sense to provide for continued application of the old Article 8 rules to lawsuits pending before the effective date. Second, there are some limited circumstances in which prior law permitted perfection of security interests by methods that are not provided for in the revised version. Section 8-313(1)(h) (1978) permitted perfection of security interests in [securities](#) held through intermediaries by notice to the intermediary. Under Revised Articles 8 and 9, security interests can be perfected in such cases by control, which requires the agreement of the intermediary, or by filing. It is likely that secured parties who relied strongly on such collateral under prior law did not simply send notices but obtained agreements from the intermediaries that would suffice for control under the new rules. However, it seems appropriate to include a provision that gives a secured creditor some opportunity after the effective date to perfect in this or any other case in which there is doubt whether the method of perfection used under prior law would be sufficient under the new version.