

# HOUSE BILL REPORT

## HB 1183

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### As Reported By House Committee On:

Law & Justice

**Title:** An act relating to updating uniform commercial code provisions on investment securities.

**Brief Description:** Updating uniform commercial code provisions on investment securities.

**Sponsors:** Representatives Appelwick and Hickel.

### Brief History:

#### Committee Activity:

Law & Justice: 1/25/95, 1/31/95 [DPS].

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## HOUSE COMMITTEE ON LAW & JUSTICE

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 15 members: Representatives Padden, Chair; Delvin, Vice Chair; Hickel, Vice Chair; Appelwick, Ranking Minority Member; Costa, Assistant Ranking Minority Member; Carrell; Chappell; Cody; Lambert; McMahan; Morris; Robertson; Sheahan; Smith and Veloria.

**Staff:** Edie Adams (786-7180).

**Background:** Article 8 of the Uniform Commercial Code (UCC) governs transfers of investment securities, including stocks and bonds, mutual fund shares, and United States government securities. Originally, transfers of investment securities were accomplished by the physical delivery of the security certificate from the seller to the buyer with a surrender of the certificate to the issuer so that registration of the transfer on the records of the issuer could be made. This process of physical transfer of security certificates became too burdensome, leading to a call for the elimination of the physical certificate and development of an "uncertificated securities" system where transfer of the security occurred electronically.

The uncertificated securities system contemplated that changes in ownership would continue to be reflected by changes in the records of the issuer, but rather than surrendering the certificate, an instruction would be sent to the issuer to register the transfer. Amendments were made to Article 8 of the UCC to provide a system for

the transfer of uncertificated securities. However, this uncertificated securities system has not developed to any relevant extent.

For the most part, a system of indirect holding of securities predominates. In this system, a depository institution holds the certificates for its members--brokers and banks. These brokers and banks in turn hold the securities for their customers--individual investors. Transfers of investment securities occur through adjustments to the brokerage accounts held with the depository institutions and the investor accounts held at the brokerage firms. Transfers are not reflected on the records of the issuer of the investment security. The current version of Article 8 does not deal in any detail with this type of indirect holding system.

### **UCC Article 8**

Article 8 governs the mechanisms by which interests in investment securities are transferred, and the rights and duties of those who are involved in the transfer process. Generally, the provisions of Article 8 allow for the free transferability of investment securities by limiting the effect of unknown adverse claims. Article 8 is organized into four parts. Part 1 contains definitions and general matters. Part 2 relates to the obligations of an issuer of a security interest, and sets forth rules precluding the issuer from asserting defenses against subsequent purchasers of an investment security. Part 3 deals with the rights of a purchaser or transferee of an investment security, providing protections for purchasers against adverse claims. Part 4 concerns the registration of a transfer of an investment security by the issuer of the investment security.

### **UCC Article 9**

Article 9 of the UCC governs security interests in personal property or fixtures. A security interest is the interest of a creditor in property of a debtor used to secure payment of a debt. Article 9 provides methods of creating and filing a security interest and the manner in which security interests may be "perfected." Perfection of a security interest is the means by which a secured creditor obtains priority over other creditors who have a security interest in the same collateral.

Under Article 8 and Article 9 of the UCC, a security interest in an investment security may only be perfected by the physical delivery of the investment security to the secured creditor.

### **Uniform Act for Simplification of Fiduciary Security Transfers**

Chapter 21.17 RCW, the Uniform Act for Simplification of Security Transactions, provides that an issuer of an investment security has no duty of inquiry to determine whether a fiduciary who is transferring an investment security is acting rightfully.

The act also provides that an issuer of an investment security may be liable for registering a transfer when the issuer has actual knowledge of an adverse claim to the investment security.

### **Summary of Substitute Bill:**

#### **UCC Article 8**

Article 8 is substantially rewritten to incorporate provisions relating to the indirect holding system. Parts 2, 3, and 4 are rewritten, simplifying the rules relating to uncertificated securities and deleting provisions relating to indirect holding systems. Parts 2, 3, and 4 apply only to the rights of people and institutions who hold certificated and uncertificated securities directly with the issuer.

Part 5 is added providing rules regarding the indirect holding system. The part sets up a right, called a "security entitlement" which is a property right that a person acquires in the contents of a securities account with a securities intermediary. This term includes an investor's account with a broker, and a brokerage firm's account with a depository institution.

A "securities entitlement" guarantees an entitlement holder a priority in the financial assets held in that account over the securities intermediary or the creditors of the securities intermediary. A securities intermediary has a duty to maintain a sufficient quantity of securities to satisfy all of its entitlement holders, to pass through to the entitlement holder all rights of ownership of the security (e.g., voting rights), and to comply with communications from the entitlement holder directing a transfer or redemption of a financial asset in the account. A "security entitlement" may be used as collateral to obtain credit.

#### **UCC Article 9**

Article 9 of the UCC is amended to adapt its provisions to the new concept of a security entitlement. Provisions concerning a security interest in an investment security formerly contained in Article 8 are moved to Article 9.

A security interest in an investment security or a securities entitlement may be created in the same fashion as a security interest in any other form of property, by an agreement between the debtor and the secured party. A security interest may be perfected by "control," defined as taking the necessary steps to place the creditor in a position where it can have the collateral sold without further cooperation of the debtor. A security interest may also be perfected by filing a security statement.

#### **Other Provisions**

The Uniform Act for Simplification of Fiduciary Security Transfers, Chapter 21.17 RCW, is repealed.

**Substitute Bill Compared to Original Bill:** The substitute bill provides a certain date, December 31, 1995, through which a security interest perfected prior to the passage of the act remains in effect. An effective date of July 1, 1995 and an emergency clause are added.

**Appropriation:** None.

**Fiscal Note:** Not requested.

**Effective Date of Substitute Bill:** The bill contains an emergency clause and takes effect on July 1, 1995.

**Testimony For:** Current law governing investment securities is very difficult to understand and does not handle the way most investment securities are held and transferred. This gap in the law creates uncertainty about the rights and duties of parties involved in investment security transfers. This bill is the product of widespread input from every major interest and is widely supported.

**Testimony Against:** None.

**Testified:** Daniel Ritter, Washington State Bar Association (pro); and David Goldstein, Washington State Bar Association (pro).