

# SENATE BILL REPORT

## SB 5335

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As Reported By Senate Committee On:  
Financial Institutions & Housing, February 21, 1995

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

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

**Sponsors:** Senators Smith, Long and Johnson.

**Brief History:**

**Committee Activity:** Financial Institutions & Housing: 2/9/95, 2/21/95 [DPS].

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### SENATE COMMITTEE ON FINANCIAL INSTITUTIONS & HOUSING

**Majority Report:** That Substitute Senate Bill No. 5335 be substituted therefor, and the substitute bill do pass.

Signed by Senators Prentice, Chair; Fraser, Vice Chair; Hale, Roach, Smith and Sutherland.

**Staff:** David Cheal (786-7576)

**Background:** The National Conference of Commissioners on Uniform State Laws, with representation from every state, develops a number of laws which it recommends to states for enactment. The NCCUSL developed the Uniform Commercial Code (UCC), and continually develops amendments to keep pace with commercial practice.

The UCC is composed of several articles dealing with such things as sales, commercial paper, checks and drafts, securities, and secured transactions. The Uniform Commercial Code and recent proposed amendments have been adopted in Washington.

Article 8 of the UCC deals with the issuance, recording, transfer, and security interests in investment securities.

NCCUSL developed major amendments to Article 8 in 1977 which have been adopted in virtually every state, including Washington. These amendments were designed to deal with uncertificated securities. Transfer of paper certificates as evidence of ownership of a security had become extremely cumbersome. It was believed that technology would lead us toward electronic recording of ownership and transfer of interests in securities. The amendments also assumed that ownership and creation of security interests would normally be accomplished by sending instructions to the issuer. Neither of these assumptions proved correct. Almost all publicly traded securities are still issued in certificated form, but they are held in large clearing corporations. Changes in ownership or the creation of security interests occur by changes on the records of these clearing corporations or other financial intermediaries. The largest clearinghouse, the Depository Trust Company (DTC), is the shareholder of record of a high percentage of publicly traded securities. It holds these

securities for the benefit of 600 or so broker/dealers and banks. They, in turn, may hold interests for other financial intermediaries in an ownership pyramid which broadens and eventually extends to the beneficial owners.

The principal method for transferring interests in securities today is a system of netted settlement arrangements and accounting entries on the books of a multi-tiered pyramid of securities intermediaries. The basic problem that lead to the current proposed amendments to Article 8 is that the current law is keyed to the concept of transfer of physical certificates or the registration of transfers on the books of issuers, yet that is not how changes in ownership are actually reflected in the modern securities holding system.

**Summary of Substitute Bill:** Article 8 is now composed of six parts: (1) general provisions; (2) issue and issuer; (3) transfer of certificated and uncertificated securities; (4) registration; (5) security entitlements (a new part); and (6) transition and conforming amendments to other articles.

The revisions acknowledge both the traditional direct holding system of security certificates, including any uncertificated version of a direct holding system that might develop in the future, and the system of intermediary holding that is now widespread.

With respect to the direct holding system, basic concepts and rules have been retained. Innocent purchasers are protected against adverse claims by applying some of the principals from negotiable instruments law.

The new part 5 develops new rules specifically designed for the indirect holding system. The approach is to describe the package of rights of a person who holds a security through a securities intermediary. The concept is labeled "a security entitlement." Part 5 describes the rights and property interests that comprise a security entitlement. The basic rule is that a person acquires a security entitlement when the securities intermediary credits the financial asset to the person's account. The remaining provisions specify the content of the security entitlement concept. For example, financial assets held by an intermediary are not the property of the intermediary, and are not subject to claims of the intermediary's creditors. Responsibilities of intermediaries are defined and rights of security entitlement holders are articulated.

Securities are often pledged as security for loans or other commercial transactions. This creates a security interest in the investment property held by, for example, a lender. Currently, many of the provisions relating to security interests in investment properties are contained in Article 8. Most of these provisions are moved to Article 9, which deals with the whole range of secured transactions law. These changes, along with transition provisions and necessary conforming amendments to other articles, are contained in Part 6.

**Substitute Bill Compared to Original Bill:** The original bill provided that security interests in securities perfected under previous law remain perfected without further action for a period of four months after the effective date of the act. The substitute bill changes this four-month period to a date certain, December 31, 1995. A specific effective date for the entire act of July 1, 1995, is added.

**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill takes effect on July 1, 1995.

**Testimony For:** Current legal rules regarding transfer, ownership, recording and security interests in securities do not reflect or serve the realities of business practice. Particularly, the widespread system of indirect holding of securities needs new legal rules.

**Testimony Against:** None.

**Testified:** David Goldstein, Washington State Bar Association (pro).