ABSTRACT

This thesis describes and analyzes the practice of 're-pledge', by which pledgees use the pledged collateral to secure their own borrowings from a third party. It focuses on re-pledge practices when the collateral is securities held with an intermediary, using Articles 8 and 9 of the US Uniform Commercial Code as the starting point, that being the most developed regime. The thesis identifies the policy choices underlying re-pledge and the international developments in this area of law, particularly focusing on the choice of law rules developed by the Hague Conference and in the European Union. Finally, the substantive rules enacted in the EU pertaining to re-pledge are reviewed. The thesis concludes that the indirect holding of securities and the practice of re-pledge has had a significant impact on traditional concepts of property and ownership and that this weakening of the property concept largely is due to deference to market realities.

RÉSUMÉ

Cette thèse décrit et analyse la pratique du droit d'utilisation, pratique par laquelle les créanciers garantis utilisent des fonds collatéraux, qui leurs ont été engagés par une transaction ultérieure, pour sécuriser leurs emprunts d'une *tierce* partie. L'analyse repose sur la mis en œuvre des droits d'utilisation quand les fonds collatéraux en question sont des valeurs détenues par un intermédiaire à la lumière des articles 8 et 9 de la *Uniform Commercial Code*. Cette thèse identifie les politiques sous-jacentes le droit d'utilisation et son développement en droit international, se concentrant particulièrement sur les règles de la loi applicable des droits d'utilisation développés lors de la Conférence de la Haye et par l'Union européenne. Dernièrement, les règles concernant le droit d'utilisation promulguée par l'UE seront discutées. Cette thèse conclue que la détention indirecte des valeurs et la pratique des droits d'utilisation a eu un effet considérable sur les notions traditionnelles de la propriété et de la possession. Cet affaiblissement des notions de propriété est attribué à une déférence marquée face aux réalités du marché.

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1. INTRODUCTION

In modern financial markets, securities[1] are held with and transferred through securities intermediaries. Ownership is not evidenced by possession of physical share certificates, but rather by book-entries on accounts held with these intermediaries. (Securities intermediaries are banks or securities brokers or dealers who trade in securities for their customers, acting as buying and selling agents, in the course of which they establish accounts for the customers to which they credit the securities.)

Interesting conceptual effects on the traditional idea of property occur when physical possession is thus abandoned. Property concepts are also affected by and affect the widespread practice known as 're-pledge', meaning the use by intermediaries of securities pledged to them by their customers as collateral to secure their own borrowings from their own secured creditors. Re-pledge is used not only by intermediaries, but also commonly by other secured parties in the market, e.g. in 'OTC derivatives transactions'[2].

It seems counterintuitive that one person can rightfully pledge securities belonging to another, as if that person were the owner. In the US, re-pledge traditionally found its legal justification in the owners' consents, as previously required by the Uniform Commercial Code[3] (the 'UCC'). This changed with the 1999 revision of Article 9 of the UCC, which now entitles secured parties to re-pledge collateral[4] without prior

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[1] Securities is defined in UCC § 8-102(a)(15) and the definition encompasses, most importantly, certificated and uncertificated shares. See more in section 1.1.2 below.

[2] OTC derivatives transactions are described in section 1.2.2 below.

[3] Re-pledge is, and was, regulated in UCC § 9-207, which is elaborated on below in section 1.2.4. Any reference in this paper to a 'Section' is to a Section in the UCC. 'Article' also generally refers to an Article in the UCC, unless otherwise indicated or evident by context. References in footnotes marked by '§' indicates a Section in the UCC.

[4] § 9-207 uses the word 'collateral' but re-pledge is actually only pertinent to types of collateral that are such that they may be in someone's possession or control. Also, some types of collateral are excluded from the regulation of re-pledge, as prescribed in § 9-207(d)(2). This thesis focuses only on collateral in form of securities held in securities accounts.

consent. That change was the inspiration for this thesis. In view of the intellectual influence wielded by seminal Articles 8 and 9 of the UCC, the importance of these provisions extends well beyond US borders.

Re-pledge raises a variety of conceptually and practically interesting questions: To what extent does re-pledge correspond with traditional conceptions of ownership rights? What type of property right does a holder of indirectly held securities actually obtain? A corollary question is how to characterize a pledge of collateral which in turn may be re-pledged? The substantive part of this paper is devoted to an in-depth discussion of these questions and their more general implications for ideas about property rights and secured lending and the legal and policy debates currently revolving around those ideas. In this context, the three-party relationship between the customer, the intermediary and the intermediary's pledgee is crucial, and we shall see that the implications are most significant at the level of priority competitions. In practical terms, the original pledgor's ownership rights in the event of default by the secured party vis-à-vis its own pledgee will largely depend on the original pledgor's priority status against that re-pledgee.

With the ever-increasing internationalization of commerce and finance, the choice of law issues within the area of re-pledge are becoming increasingly important, particularly in light of the prevailing disharmony among different legal systems at the substantive level. Work on a choice of law convention is currently being undertaken within the Hague Conference on Private International Law (the 'Hague Conference'); the proposed rules will be reviewed and compared with the choice of law rules in the UCC.

The remainder of this first introductory section describes the indirect holding system for securities in the USA and the US rules pertaining to holdings within that system. After that introductory review, section 2 of the paper deals with the policy choices that underlie the structure of the markets and the rules regulating secured transactions and re-pledge in the US. Section 3 asks the questions of the greatest importance, i.e. what do the property rights granted to holders in the indirect holding system actually entail, and how should 're-pledgeable' pledges be characterized. To answer these questions requires a more general review of the concept of property as well as some of its core features and consequences. This review will serve as the introduction to section 3 of the paper.

Sections 4 and 5 take a somewhat more international outlook. Choice of law-issues related to re-pledge are discussed in section 4, where the rules in the UCC will be described and compared with the rules in the proposed convention of the Hague Conference.[5] The choice of law rules already implemented in the European Union's (the 'EU') Collateral Directive[6] will also be mentioned in passing. Section 5 looks at the work being undertaken in the EU towards the integration of financial markets and the establishment of uniform rules for re-pledge, and contrasts some of the policy choices made with those in the UCC. Section 6 offers concluding observations based on the recurring themes identified in the preceding sections.

1.1 The Indirect Holding System

Securities are almost always held through an Indirect Holding System ('IHS'), the rules for which, as regards the US market, are set out in article 8 of the UCC. It is

[5] See below in section 4.3 for more about the Hague Conference and the proposed Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

necessary to understand this system and the applicable UCC rules before discussing re-pledge and its applications and implications. Re-pledge invariably involves securities held in this system, and its structure and rules, particularly those on priority, determine the rights of the parties. Indeed, as will be seen, the market structure has had a great impact on the content of the legal rules.

1.1.1 The DTS-NSCC System

Traditionally, the ownership of securities was evidenced by possession of share certificates and changes in ownership were accomplished by delivery of those certificates.[7] With the vast growth after World War II in investments markets this practice became time-consuming, costly and labor intensive to an unmanageable extent. By the end of the 1960s, the need for a modern paper-less transfer system had become apparent. It was in response to this need that Article 8 was revised in 1978.

The 1978 revisions envisioned a system in which changes in ownership etc. of securities would be evidenced on the records of the issuer, but no physical certificates would be issued, i.e. the securities would be 'uncertificated'. The 1978 revisions are viewed largely as a failure, partly because they came too late; the markets in the meantime had instigated a system of immobilization and netting to solve the 'paper crunch'.[8] This immobilization system still depends on the underlying concept of certificated securities, but, as explained below, the certificates are not actually

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[6] *Infra* note 307

[7] Hawkland & Rogers, *UCC Series § - (Rev Art 8)* (New York: Clark, Boardman, Callaghan, 1996) at 3. The following description of the IHS in this section 1.1.1 is based on this reference unless otherwise indicated; see Hawkland & Rogers at 2-15.

[8] Schroeder, J.L., "Is Article 8 Finally Ready this Time? The Radical Reform of Secured Lending on Wall Street" [hereinafter Schroeder: Radical Reform], [1994] Colum. Bus. L. Rev. 291 at note 74

transferred. Consequently, the 1978 revisions were not adapted to the factual realities of immobilized securities trading and were outdated even before being promulgated.

The immobilization system depends on the Depository Trust Company ('DTC'), a limited purpose trust company, organized under New York law, that holds securities as a depositary for the approximately 600 banks and broker-dealers which constitute the trust's participants. DTC uses the name Cede & Co ('Cede') as its nominee and Cede is listed as the shareholder of record of approximately sixty to eighty per cent of the outstanding shares in all publicly traded companies in the US market. Since almost all of the trading in these companies is effected through the banks and broker-dealers that participate in the DTC, the trading process is significantly facilitated by the fact that everything is pooled through the DTC. All changes of ownership are accommodated by adjustments to the participants' accounts with the DTC and transfers of certificates between the dealers are thus not necessary. This is what is known as immobilization.[9]

An end-of-day netting process serves to decrease the number of record entries within the DTC. This function in the US is performed by the National Securities Clearing Corporation ('NSCC'). The NSCC computes all trades between two dealers in any security on any day and then calculates the net receive and delivery obligations of each party. The DTC then makes the required changes to each party's account. The system would be much less manageable if every transaction between two parties had to be recorded in their accounts. The banks and broker-dealers themselves perform the same netting process internally for transactions between their customers, which means that their positions with DTC need not be changed. An additional advantage of netting is that

[9] *Ibid.* at note 78

it effectively decreases the parties' net obligations towards each other, which in turn lessens the systemic risk of one market participant's failure.[10]

The DTC system is open to almost all publicly traded corporate equity securities, corporate debt securities and municipal debt securities in the US. Similar netting systems are in place for mortgage-backed securities (Participants Trust Company) and for US Treasury securities (the Federal Reserve System).

The DTC system does not create a direct link between the beneficial owner of the security and the issuer as the issuer's records show only the name of the depository, whose own records in turn will designate only the intermediary. It is not until the intermediary's records are consulted that one learns the identity of the beneficial owner.

Since the IHS was not contemplated by the 1978 revisions to the UCC, further revisions to Article 8 were required and these were effectuated in 1994. The drafters took the view, probably with the failure of the 1978 revisions in mind, that Article 8 should not purport to influence the development of the market structure and that the direct and indirect holding systems were so inherently different as to require separate legal regulations. The prior rules were thus retained for the direct holding system, and a new Part 5 of Article 8 was added to regulate the IHS.

The vast majority of investments in securities are currently made through the IHS and this paper will focus on issues related to such indirect holdings. Indirect holding is increasingly the norm not only within the US, but in most modern economies, and most countries have set up similar systems for securities trading. This paper focuses on the US rules in the UCC mainly because those rules are the most evolved. There is arguably no

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[10] Mooney Jr., C.W. "Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries" [hereinafter Mooney: Beyond Negotiability] (1990) 12 Cardozo

other jurisdiction that has taken an equally comprehensive approach to regulating the HIS and secured lending practices. Articles 8 and 9 therefore have and will continue to have an enormous influence on legal developments in these areas outside the US. Confining the scope of this paper to the IHS context is warranted by the fact that the circumstances in which re-pledge is most likely to occur involve collateral in the form of securities held in the IHS.[11]

1.1.2 Overview of Part 5 of Article 8

The rules for the IHS are set out in Part 5 of Article 8 – Security Entitlements. A number of definitions are important for the effective operation of Part 5. First, there is the definition of *security entitlement*[12]:

> "Security entitlement" means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5

As used in this definition, the term *entitlement holder*[13] means any person who holds a security entitlement against an intermediary. The term *financial asset*[14] is defined, first as a *security*, but it also includes a broader category of obligations, shares, participations and interests. The definition also contains an opt-in provision that enables an intermediary and its customer to expressly agree that property held in a securities account shall be treated as a financial asset.

Law Review 305 at 319, in note 32. For further discussion on systemic risk, please see section 2.2 below.

[11] Kettering, K.C., "Replede Deconstructed" [hereinafter Kettering] (1999) 61 U. Pitt. L. Rev. 45 at 59. See more on this in section 1.2.2.

[12] § 8-102(a)(17)

[13] § 8-102(a)(7)

[14] § 8-102(a)(9)

The baseline definition of a *security*[15] is "an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer". This general description is conditioned by three requirements: the interest or obligation must (i) be fully transferable, (ii) meet a divisibility-test, and (iii) be of a type dealt in or traded on securities markets or securities exchanges.

The term *securities account*[16] 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

A security entitlement is acquired when a financial asset is, or should be, credited to the entitlement holder's securities account.[17] Part 5 applies to security entitlements and the definition of securities account therefore effectively establishes which relationships between financial institutions and their customers are covered by the rules in Part 5.[18] In current trading practices, the relationships between clearing corporations and participants, between brokers and customers who deposit their securities with the broker and between banks acting as securities custodians and their custodial customers clearly fall within the definition.[19] Whether other arrangements should also be considered securities accounts depends on the substantive provisions interpreted in light of the particular parties' expectations.[20] Although an intermediary must promptly obtain and maintain sufficient financial assets to satisfy all of its customers' claims, the customer obtains a security

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15 § 8-102(a)(15)
16 § 8-501(a)
17 § 8-501(b)
18 Official Comment 1 to § 8-501. The Official Comments of the UCC are hereinafter in the text referred to as 'the Comments'.
19 *Ibid.*

entitlement regardless of whether or not the intermediary fulfills this duty; this ensures that the parties relationship is still subjected to the rules in Part 5.[21]

Section 8-503 sets out the rights of an entitlement holder. It stipulates that the financial assets held by an intermediary for a holder are not the intermediary's property and not subject to the claims of the intermediary's general creditors. Section 8-503(b) describes the holder's property interest as a pro rata interest in all financial interests held by the intermediary in that financial asset, regardless of when the entitlement was acquired.[22] Although thus described as a property interest, the Comments observe that since tracing of discrete securities is impossible within the HIS, the entitlement holder's only real recourse is to look to the intermediary for performance of its obligations.[23]

The main obligation of the intermediary is set out in Section 8-504. The intermediary is required to maintain financial assets in a quantity corresponding to the aggregate of all security entitlements in relation to those assets that it has established in favor of its entitlement holders. Subsection (b) states that the intermediary may not grant a security interest in any financial asset that it is obligated to maintain pursuant to subsection (a), unless the entitlement holder consents. The statutory right to re-pledge granted by the 1999 revision to Article 9 is therefore not extended to cases where the customer is an entitlement holder. Since standard form agreements between intermediaries and customers typically authorize intermediaries to effect a re-pledge, the availability of a statutory right of re-pledge becomes important primarily where the

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[20] *Ibid.*

[21] § 8-501(c)

[22] What this property interest actually contains and how it relates to traditional notions of property will be discussed in section 3.2 below.

[23] Official Comment 2 to § 8-503. This aspect of the property right under Part 5, Article 8 is discussed below in section 3.2.3.

customer is no longer an *entitlement holder* or when the re-pledge involves parties other than securities intermediaries and their customers.[24]

1.2 Re-pledge in context

1.2.1 Re-pledge: Concept and Definition

In this paper, re-pledge does not denote a situation in which a debtor grants successive security interests in the same item of property to two different secured parties. Rather, for the purposes of this paper, as well as in popular commercial usage, re-pledge means a pledge of an original pledgor's collateral *by the pledgor's secured party* to secure the latter's own obligation to a third party. The actors are thus three: 1) the original pledgor and owner of the collateral, 2) the pledgor's secured party, in favour of whom the original pledge is made, and 3) the initial secured party's own secured creditor, who takes a security interest in the original pledgor's collateral to secure its lending to the Secured Party. Hereinafter the terms 'Pledgor', 'Secured Party' and 'Re-pledgee' will be used respectively for these actors, unless otherwise indicated or necessitated by context.

1.2.2 Re-pledge: Commercial Context

Re-pledge has traditionally been used by stockbrokers in what is known as *margin lending*.[25] In margin lending, the stockbroker (the Secured Party) makes a loan to its customer (the Pledgor), representing a portion of the cost of purchasing or carrying

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[24] Official Comment 2 to § 8-504. It may also be noted that the specific duty to maintain financial assets in Section 8-504 is complemented by the more general specification of duties in Section 8-509. In turn, this latter Section refers to other statutes, regulations or rules for the substance of the duties. When the intermediary is in compliance with any such "additional" body of rules it is also deemed to be fulfilling its duties under Sections 8-504 through 8-508. Where no "additional" rules exist, the intermediary must fulfill its duties in a *commercially reasonable manner*.

[25] Kettering, *supra* note 11 at 51 for the following description of margin lending.

securities for the customer's account. The stockbroker will generally require a pledge of the securities thus purchased (in this context sometimes referred to as *margin securities*). Most brokers are not able to finance margin lending out of their own capital and will therefore need to obtain third party financing from, most commonly, a bank (the Re-pledgee). The bank loan will be secured by a re-pledge of the customer's margin securities.

Today, re-pledge also occurs in the context of 'over-the-counter derivatives transactions' ('OTC derivatives').[26] A derivative has been described as "...a bilateral contract or payment exchange agreement whose value is linked to, or derived from, an underlying asset (such as a currency, commodity or stock), reference rate (such as the Treasury Rate, the Federal Funds Rate or LIBOR), or index (such as the S&P 500)."[27]. The principal reason for entering into derivatives transactions is to hedge against, or speculate on, price movements in the assets, rates or indexes that form the base of the contract. OTC derivatives are non-standardized contracts that are used to meet the divergent risk management needs of different market participants.

During the term of an OTC derivative contract, one or both of the parties may become obligated to make payments to the other over time, depending on fluctuations in the underlying denominator. The contracts usually prescribe that the present value of these future obligations be determined periodically and that the net obligor under the contract provide security for its future payment obligation. Collateral provided as such

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[26] *Ibid.* at 54

[27] Krawiec, K.D., "More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives" (1997) 23 Iowa J. Corp. L. 1 at note 17. See *ibid.* and Kettering, *supra* note 11 at 54 for the following description of OTC derivatives.

security is usually US Treasury or other marketable securities, both of which are almost invariably held indirectly with securities intermediaries.[28]

Frequently, one of the parties in an OTC derivatives transaction is a dealer in such transactions. In order to protect itself against the risks arising from its multiple contracts, the dealer will enter into offsetting transactions for each derivative with a third party. The dealer will usually require the right to re-pledge the collateral it receives in these contracts as security for its own obligation under the corresponding offsetting contract. The standard documentation drafted by ISDA[29] provides for such a right, as well as the right to actually sell the collateral prior to default.

Securities lending transactions are transactions in which a party borrows a particular security subject to the obligation to return the same security at a later date, and secures this obligation by pledging US Treasury securities or similar collateral. The lender will almost invariably obtain the right to re-pledge or sell the collateral.[30]

1.2.3 Overview of Section 9-207: Collateral and Control

Section 9-207 is entitled 'Rights and Duties of Secured Party Having Possession or Control of Collateral'. Re-pledge is specifically addressed in Section 9-207(c)(3)

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[28] See also Facciolo, F.J., "Father Knows Best: Revised Article 8 and the Individual Investor" [hereinafter Facciolo], (2000) 27 Fla. St. U.L. Rev. 615 at 673 who explains that even though almost all US Treasury securities nowadays are uncertificated and investors are able to register their ownership directly with the Treasury through the TREASURY DIRECT system, holdings will in practice nevertheless be deposited with intermediaries. This is due to the facts that transfers via TREASURY DIRECT are almost as cumbersome as transfers with delivery of certificates and that a holder in the TREASURY DIRECT system is not allowed to create a security interest in that holding.

[29] The International Swaps and Derivatives Association. For more information about the ISDA master agreement, see Johnson, C.A., "Derivatives and Rehypothecation Failure: It's 3:00 p.m., Do You Know Where Your Collateral Is?" [hereinafter Johnson: Derivatives] (1997) 39 Ariz. L. Rev. 949 at 957 f.

[30] Kettering, *supra* note 11 in note 23 and in note 22, where he explains that re-pledge sometimes also is used by clearing corporations. If a participant fails, the clearing corporation will be required to complete settlement and it might therefore need to borrow funds. This borrowing will require a grant of security, which usually will be a re-pledge of securities originally provided as collateral by one of the participants. Clearing corporations are subject to special rules under Article 8 which will not be discussed here.

which states that a secured party who is in possession or control of collateral may create a security interest in the collateral.

The term *collateral*[31] is defined in broad terms as property that is subject to a security interest. It could thus be any type of personal (moveable) property, not just investment property. However, the secured party must be in *control* or *possession* of the collateral to be able to re-pledge it. This effectively limits the right of re-pledge to those types of property over which it is possible for a secured party to take possession or control. Control over certificated and uncertificated securities or over security entitlements is regulated by Section 9-106, which, in turn, refers back to Section 8-106.

As explained previously, this paper is only concerned with security entitlements in the IHS. Section 8-106(d) sets out the two ways in which a purchaser, a term which is defined to include a secured party, can obtain control in this situation.[32] First, the purchaser, i.e. the Secured Party using the terminology explained in section 1.2.1 above, can become the entitlement holder of the security entitlement by having it transferred to its own securities account. Alternatively, the Secured Party can obtain control by entering into an agreement under which the securities intermediary agrees to comply with entitlement orders from the Secured Party without any further consent from the entitlement holder. Subsection (e) sets out a special provision for when the Pledgor grants interests in security entitlements to his or her intermediary. The intermediary is then deemed to have control. The transactions to which this provision applies include margin loans made by stockbrokers to their customers.[33]

[31] § 9-102(a)(12)
[32] Official Comment 1 to § 8-106
[33] Official Comment 6 to § 8-106. For more on margin lending, see section 1.2.2 above.

The key to the concept of control is that the Secured Party must be in a position where it is able to sell the Pledgor's securities without having to obtain the consent or co-operation of the Pledgor.[34] It is not necessary that the Pledgor's power to deal with its securities be completely terminated. It is sufficient if the Secured Party has the unilateral power to dispose of the securities, whether or not that power is exclusive.[35]

Section 9-314 addresses control as a method for perfecting a security interest. Under subsection (c), a Secured Party's security interest in a security entitlement remains perfected by control until he or she no longer has control and the Pledgor is or becomes the entitlement holder. The purpose of this provision is to allow the Secured Party to effectuate a re-pledge in which he loses control, but still have a perfected security interest as against the Pledgor.[36]

1.2.4 Statutory Re-pledge under Section 9-207

Re-pledge of securities are commonplace today, whereas it is almost non-existent for other types of collateral.[37] The 1999 revision of Article 9 provided a statutory right for a secured party to create a security interest in specified collateral in its possession or

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[34] Official Comment 1 to § 8-106

[35] Official Comment 7 to § 8-106. See also Schroeder: Radical Reform, *supra* note 8 at note 242, who points out that there are also some instances in which the Secured Party has the ability to sell the securities, but will not be deemed to be in control under the rules in Part 5.[35] This is the case, e.g., when the Secured Party has obtained an irrevocable power of attorney to dispose of the collateral. The concept of control does not cover this scenario since the power of attorney only constitutes a bilateral agreement between the Pledgor and the Secured Party. One of the requirements for control in Section 8-106(d) is that the intermediary has agreed to "comply with entitlement orders originated by the purchaser". This qualification is probably due to the drafters' wishes to limit the cases in which intermediaries might be faced with conflicting entitlement orders, which in turn would lead to insecurity and potential liability for the intermediaries.

[36] Kettering, *supra* note 11 at 208

[37] *Ibid.* at 51

under its control.[38] One of these categories of collateral is *investment property*[39], defined as follows:

> a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract or commodity account

It is evident from this definition that investment property is a comprehensive category designed to establish uniform treatment for the specified types of assets in the context of secured transactions. Special rules are set out for, e.g., how control is obtained over investment property or how a security interest attaches to such property.

Even before the revisions to Article 9 created a statutory right of re-pledge, re-pledge was commonplace owing to the inevitable consents given by the customers of securities intermediaries. The revision has not changed the fact that a secured party's statutory right to re-pledge can be varied or limited or excluded by agreement between the parties if the Secured Party so agrees.[40] Nevertheless, the fact that the right to re-pledge is now the default legal rule has some consequences. Most obviously, it reverses the starting point for negotiations between Pledgors and Secured Parties. Previously, Secured Parties had to positively bargain for the right to re-pledge whereas now the burden of negotiation has shifted to the Pledgors.[41] Unsophisticated Pledgors may not be aware of the practice of re-pledge and thus of their ability to avoid it by agreement. Before the revision, re-pledge would at least have been brought to their attention by the fact that they were required to consent to it.

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[38] § 9-207(c)(3)
[39] § 9-102(a)(49)
[40] Kettering, *supra* note 11 at 176
[41] *Ibid.* at 186

Taking a broader perspective, the emergence of a statutory right to re-pledge can be read as a statement about property rights and their place in this area of commercial law. Property rights in a secured transaction are closely connected to a debtor's general right to redeem ownership of the collateral on satisfaction of the secured obligation.[42] The pre-1999 version of Article 9 permitted re-pledge without the consent of the Pledgor only as long as the terms of the re-pledge did not impair the Pledgor's right to redeem.[43] This qualification has been removed in the 1999 revision; the Secured Party is empowered to "create a security interest in the collateral" without any explicit preservation of the Pledgor's right to redeem ownership.

According to the Comments,[44] the deletion of the reference to redemption found in Prior Section 9-207 was not intended to affect any material change and the Pledgor's general right to redemption under Article 9 is still preserved.[45]

On the other hand, the Pledgor and the Re-pledgee will have competing interests in the same collateral after a re-pledge has been effectuated, and, under the UCC priority rules, this competition will almost invariably be won by the Re-pledgee.[46] The Comments concede that the *right* of redemption is not affected by the Secured Party's re-pledge, but that the *practical ability* to redeem the collateral might be impaired.[47] This may be technically correct, but the distinction will be cold comfort for the Pledgor.

The Comments further state that the Pledgor's right to redeem the collateral only amounts to a personal claim against the Secured Party, in case the latter fails to restore

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[42] Under Section 9-623 the Pledgor has a right to redeem the collateral upon fulfillment of all obligations secured by the collateral and applicable fees and expenses.

[43] Official text 1998, UCC 9-207(2)(e), which reads: "the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it.", hereinafter 'Prior Section 9-207'.

[44] Official Comment 5 to § 9-207

[45] *Ibid.*

[46] Official Comment 6 to § 9-207

the collateral.[48] The Secured Party will only be unable to meet its redemption obligation when it is insolvent or otherwise in financial distress. A right that merely consists of a personal obligation owed by an insolvent debtor is likewise of cold comfort to a Pledgor.

1.2.5 Other Regulations of Re-pledge

The UCC is not the only source of the law on re-pledge in the US. The US Securities and Exchange Commission (the 'SEC') has issued regulations governing stockbrokers' re-pledges of customer securities.[49] There are parallel provisions for dealers in government securities issued by the Department of the Treasury.[50]

The SEC regulations apply to any broker-dealer who is subject to registration requirements under Section 15(a) of the Exchange Act. These rules require the broker to obtain customer consent in order to re-pledge on terms that might result in the commingling of a customer's securities with those of other customers. Brokers are prohibited altogether from re-pledging customers' securities in a manner that would permit commingling with the securities of any person other than another customer. Lastly, brokers are not allowed to re-pledge customers' margin securities in an aggregate amount that exceeds the aggregate margin debt owed to the broker by all customers. The latter two restrictions apply regardless of customer consent.

The SEC regulations make the statutory right of re-pledge in the UCC less worrisome for customers, but only if the relevant Secured Party/securities intermediary is an SEC-regulated entity. In fact, it has become increasingly common for a re-pledging

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[47] Official Comment 4 to § 9-623

[48] *Ibid.*

[49] See Rules 8c-1, 15c2-1, 17 C.F.R., Sections 240.8c-1, 240.15c2-1 (2002), issued pursuant to Sections 8(a) and 15(c)(2) of the Securities Exchange Act of 1934 (hereinafter "the Exchange Act").

Secured Party to be unregulated. Ssecurities firms often conduct their OTC derivatives through unregulated subsidiaries or through 'OTC derivatives dealers' that are exempt from the regulatory restrictions on re-pledge. Moreover, many parties to OTC derivatives are ordinary businesses who do not fall within the SEC's jurisdiction.[51]

Thus, the SEC regulations do not for the most part diminish the regulatory importance of the UCC as it applies re-pledge. Moreover, the underlying property right issues raised by the UCC rules remain significant relevant even where the SEC regulations also apply.

2. POLICY BACKGROUND

As pointed out by Professor Kettering in his comprehensive article on re-pledge, the most interesting issues raised by the revision of Section 9-207 concern the nature of the property right of an entitlement holder and, relatedly, the true characterization of a pledge which allows re-pledge.[52] These issues are discussed in section 3 below. This section reviews the background policy considerations. These policy considerations include policies that apply to law-making in general as well as policies more closely related to the IHS, namely protection against systemic risk, enhancement of efficiency within the IHS markets, investor/customer protection, and facilitation of secured lending.

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[50] See 17 C.F.R. Section 403.2 (2002)
[51] Kettering, *supra* note 11 at 64
[52] *Ibid.* at 191

2.1 General Policy Considerations

2.1.1 Clarity and Predictability

One widely accepted legislative principle, particularly in the commercial law context, is that the law should be clear and predictable. This promotes efficiency since costs, such as lawyers' fees and additional risk premiums, increase when it is difficult to predict the legal consequences of later events. In the securities markets context, legal unpredictability has been identified as contributing to the increased cost of capital, a reduction in the value of securities, increased credit and liquidity exposure and systemic risk.[53]

Concerns with predictability are not so much about what the substantive law should be; but whether the applicable rules can be safely and swiftly ascertained.[54] In other words, the predictability concern does not purport to offer any guidance about how to choose between alternative solutions that are equally clear and easy to apply.

Predictability concerns are, however, relevant to one substantive issue as regards the IHS, namely whether traditional property law constructs should be retained or a sui generis type of right constructed.[55] On this question, Professor Mooney concludes that general property rules achieve very little at the level of clarity and that a specific sui generis rule concentrating on priorities as found in the UCC is preferable.

From a predictability perspective, this conclusion seems unassailable. A rule that in its application only requires an assessment of the relevant actors' statuses within the

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[53] Guynn, R.D., "Modernizing Securites Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization – Capital Markets Forum Discussion Paper No 6" [hereinafter Guynn], International Bar Association (1996) at 5

IHS is straightforward and simple to apply; it is relatively easy to determine whether a claimant is a transferee/on an upper-tier or an owner/on a lower-tier.

Even though the priority rules become practically significant only if the Secured Party is in financial distress, the predictability of the priority regime has an impact outside of insolvency as well. The way in which priorities will be accorded must be taken into account by the parties as they structure and negotiate their transaction and will thus have an impact on the costs incurred at the outset of all transactions whether or not insolvency later materializes.[56]

2.1.2 Avoidance of Arbitrary Results and Coherence with Normative Views

Another widely-accepted policy goal in law making is the development of rules, the application of which will not produce arbitrary results, i.e. that do not come about randomly or by pure chance.[57] Legal rules should also reflect the normative views of society and people should be able to somewhat accurately predict what the law is simply by using their common sense and practical experience. Consequently, the law should not produce results that are abhorrent or counterintuitive to them.

It is difficult to analyze how this principle should play out in the abstract so full discussion will be reserved until later. However, it can be ventured at this stage that a particular rule's coherence with normative views will differ according to the policy

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[54] Related to this statement is the very important role predictability plays in the realm of choice of law. For more on that issue, please see section 4 below.

[55] Mooney: Beyond Negotiability, *supra* note 10 at 396

[56] *Ibid.* at 396 f. and Adler, B.E., "Bankruptcy and Risk Allocation" (1992) 77 Cornell L. Rev. 439 at 464, where Adler states that parties bargain for their positions with full knowledge of the allocation provisions of bankruptcy law.

[57] See Schroeder: Radical Reform, *supra* note 8 at 332 f., who calls arbitrary results "intuitively unjust". See also Kettering, *supra* note 11 at 116 f. and 126 and Rogers, J.S., "Policy Perspectives on Revised U.C.C. Article 8" [hereinafter Rogers: Policy Perspectives] (1996) 43 UCLA L. Rev. 1431 at 1516 and 1520, who in more general terms express disapproval.

choices made and the particular constituency measuring it. In the case of secured lending, priority for upper-tier parties is likely to accord with the expectations of such parties, whereas such rules may be out of step with the expectations of lower-tier market participants.

2.1.3 Legal Realism

Related to the policy issues previously discussed[58] is the view that the law should reflect the realities in which it is to be applied.[59] The evolution of the rules governing the IHS in Article 8 is, in itself, a reflection of this policy. The markets established the IHS and Part 5 of Article 8 was then developed as a 'catch-up' response to the need for the law to reflect market realities. There is nothing unusual about this. Especially in an era of rapidly developing technology, it is to be expected that the law on paper may have trouble keeping pace with developments on the ground.

However, once again, policy does not necessarily provide any insights as to the content of the resulting rules.[60] Even if the market has adopted a particular structure, there is, in principle, nothing to stop a legislator from enacting a contrary substantive regime. Normative policy choices might require a different legal response and therefore termination of the evolving market response. A contrary legislative response would create costs since the market would have to adjust. However, costs to one constituency or another are an inevitable by-product whenever any choice is made between competing policies and interests.

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[58] See sections 2.1.1 and 2.1.2.

[59] For example, see Schroeder: Radical Reform, *supra* note 8 at 297 and Rogers: Policy Perspectives, *supra* note 57 at 1455.

The re-pledge phenomenon becomes most interesting when examined within the context of the larger question of the nature of the property rights of holders in the IHS. In this connection, it is instructive to explore the policy considerations involved in devising the legal rules to regulate the IHS. If a lawmaker, as the drafters of Article 8 seem to have done, chooses a policy that favors weak property rights for one constituency, here Pledgors of securities, to support some other (presumably more important) policy, it can be assumed that the same lawmaker would have little difficulty granting strong rights to the opposite constituency, here Secured Parties, to deal with their debtors' collateral for their own account, i.e. re-pledge.

2.2 Systemic Risk

Professor Rogers, who served as Reporter to the Drafting Committee to Revise UCC, Article 8, states that the main justification for the policy balance struck by the 1994 revision of Article 8 was to control systemic risk in the securities markets.[61]

Professor Rogers defines 'systemic risk' as "the risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due."[62]. The international financial community has become increasingly concerned with systemic risk in the clearance and settlement systems for

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[60] However, it is my view that Part 5 of Article 8 largely is built on the opposite view, namely that market reality must be allowed to dictate the law and examples of such statements are found in the Official Comments to those provisions, e.g. in Official Comment 1 to § 8-503.

[61] Rogers: Policy Perspectives, *supra* note 57 at 1435 f.

[62] *Ibid.* at 1437 and note 4, in which he indicates that the definition is taken from Bank for International Settlements, Cross-Border Securities Settlements (1995). See also United States General Accounting Office, *Report to Chairman Committee on Banking and Financial Services, Payments, Clearance and Settlement – A Guide to the Systems, Risks and Issues* [hereinafter GAO Report], GAO/GGD-97-73, June 1997 at 29 for a similar definition.

securities trading, and, in Professor Rogers' view, the legal rules for securities transfers could be a contributing factor to this systemic risk in times of market crisis.[63]

When trades in securities are made, payment and delivery (i.e. settlement) does not take place until a few days after the trade is made on the 'floor'. In the U.S. corporate and the Euro securities markets, settlement usually occurs on day three after the trade (T+3),[64] and during this time clearing agents perform clearance and netting of trades and positions.[65] Deficiencies in these systems create systemic risk since systemic break-down is one of the major channels for spreading the effects of one firm's failure to others.[66] With every day that elapses from the time of the trade to the time of settlement, the failing firm will be accruing unpaid losses. The counter parties to these transactions in turn will be unable to realize gains on their unsettled trades. This may contribute to the counter party firms' inability to perform other obligations they have incurred and, ultimately, their failure too.

A countermeasure against systemic risk would seem to be to minimize the settlement periods and to ensure that the volumes traded each day can be handled by the system. These responses are the province of regulatory agencies such as the SEC.[67] However, Professor Rogers argues that the commercial law rules of Part 5 of Article 8 also alleviate systemic risk since they clarify and render predictable the legal positions of those holding securities through intermediaries.[68] Although the cause and effect relationship between reducing systemic risk and Article 8 has been questioned by other

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[63] Rogers: Policy Perspectives, *supra* note 57 at 1437
[64] Guynn, *supra* note 53 at 7
[65] GAO Report, *supra* note 62 at 50 f.
[66] Rogers: Policy Perspectives, *supra* note 57 at 1437
[67] Facciolo, *supra* note 28 at note 73
[68] Rogers: Policy Perspectives, supra note 57 at 1445

commentators,[69] clear and predictable commercial law rules are probably a useful alleviating factor. However, a systemic risk analysis by itself does not tell us anything about what the material content of those rules should be.

In this connection, Professor Rogers also proposes that the need for post-settlement finality has "a direct bearing on the objectives of clearance and settlement reform."[70]. Post-settlement finality has long been recognized as a fundamental policy of the commercial law of investment securities. In this context, the principle means that "…once a purchaser has acquired a property interest in a security by a transfer implemented through the appropriate formal mechanism, that purchaser's acquisition of the property interest cannot be unsettled on the basis of an assertion that the transferor acted wrongfully in transferring the securities to the purchaser."[71]. According to Professor Rogers, Article 8 furthers this policy by ensuring that the entitlement holder (save for exceptional cases) can only make claims regarding his or her holdings towards his or her own intermediary. Other writers have also argued that the need for finality can best be achieved by the weakening of traditional property and priority rules so as to ensure good title to later market transferees of securities.[72]

There are also critics of Professor Rogers' thesis that the need for commercial law rules that support post-settlement finality is linked to the need for reliable systems for clearance and settlement. Facciolo argues that the connection between these two objectives is very tenuous, and that there is no empirical support for Professor Rogers'

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[69] Facciolo, *supra* note 28 at 625
[70] Rogers: Policy Perspectives, *supra* note 57 at 1461
[71] *Ibid.* at 1462
[72] See Guynn, *supra* note 53 at 10 and Schroeder: Radical Reform, *supra* note 8 at 352 and 494.

concerns.[73] In Facciolo's view, clearance and settlement concerns should be implemented through improvements (through regulation if necessary) of such systems, rather than through commercial law reforms.

It goes beyond the scope of this paper to comprehensively review and assess all of the empirical studies and other sources relied on by Professor Rogers and Facciolo. Nonetheless, Facciolo's view is compelling. The need for finality, notwithstanding its obvious impact on the actions of the market, and the need for stability in clearance and settlement practices are two quite different things. Transactional finality has to do with commercial law and depends on policy choices concerning buyer/seller protection and the appropriate thresholds for admissibility of adverse claims. The settlement systems' stability, on the other hand, relates to the technical modes of trading. The former is affected by the legal rights the transferor has to alienate the securities, whereas the latter is affected by infra-structural matters. Moreover, a non-performance due to settlement failure will affect a much greater number of transactions and involve much greater dollar amounts than a legally vulnerable transfer.

Admittedly, this distinction might seem irrelevant to the parties to a securities transfer. Since they enter into subsequent transactions in reliance on the settlement and performance of previous transactions as soon as the trade has occurred, it is practically irrelevant if a failed transaction is due to the settlement system or to the vulnerable title of his or her transferee. But, this does not change the fact that systemic risk and finality concerns are two separate issues, each of which raises separate policy considerations, that need to be identified and assessed and only then brought into the balance.

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[73] Facciolo, *supra* note 28 at 630

2.3 Efficiency

2.3.1 Market Efficiency

Some commentators support reform in the clearance and settlement system primarily on the basis of the need to reduce friction or transaction costs so as to promote greater efficiency in securities markets.[74] Their theoretical starting point is that costs arising from legal uncertainties about the validity of transfers and pledges of securities prevent securities from being put to their most efficient use, leading to unnecessarily higher cost of credit and lower value of securities.[75]

Once again, while it is important to have a market that works efficiently and that accommodates transfers of securities, this objective does not yield any specific answers about the content of the legal rules. The market's ability to function efficiently depends on different criteria than the creation of a legal environment in which securities are put to their most efficient economic use. Market efficiency has already been taken care of by the market itself, in the creation of the IHS. What is more relevant is what specific legal rules on transfers will promote the most efficient use of securities.

2.3.2 Efficient Use of Securities

Identification of what legal rules will help produce the most "efficiency"[76]requires an economic analysis of the priority rules to govern disputes between competing parties

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[74] *Ibid.*

[75] *Ibid.*

[76] Efficiency is used here to mean: "If the losses (costs) imposed on society by a particular legal rule are more than offset by the gains (benefits), the rule is efficient." This definition is found in Mooney: Beyond Negotiability, *supra* note 10 at 382 in note 272, where he also lists references to sources for other definitions of efficiency.

to the same securities.[77] Professor Schroeder poses an efficiency justification for giving priority to the customers of securities intermediaries.[78] She reasons as follows. The securities market exists only because there are buyers and sellers willing to trade; the intermediaries employed in aid of that process, as well as the clearing and settlement agents, are not themselves contributing anything other than corollary services. The customers are the players that make the market go round and as such should therefore be rewarded. In her view, it seems "…intuitively backwards to favor those parasites over the host."[79].

If one believes that a securities market is a good thing (which is assumed in this paper), the same reasoning would support a legal regime that encourages owners to submit their securities to the market. Giving protection to customers against the risk of the intermediary's insolvency or an adverse claim from a transferee of the intermediary, by according priority to customers over subsequent transferees, would arguably provide a powerful incentive to customer market participation.

Professor Schroeder acknowledges that the counter-effect of such customer protection is that lending to intermediaries would be more risky and, consequently, would produce higher interest rates.[80] While that increased cost of credit would be passed on to the customers, the competition for customers would presumably make intermediaries strive to find the most efficient way of operating their businesses so that the costs imposed on customers would be held at a reasonable level.

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[77] Mooney: Beyond Negotiability, *supra* note 10 at 381 f.
[78] Schroeder: Radical Reform, *supra* note 8 at 494 f.
[79] *Ibid.* at 494
[80] *Ibid.* at 495

Professor Schroeder goes on to offer a counter-argument to her customer protection thesis. Focusing on the efficiency of the market, she concludes that it is necessary to instead provide 'good faith-buyers'[81] with full title to what they buy.[82] Market efficiency requires that the customers leave their securities with an intermediary and that the intermediary have the power to alienate these securities. When the market is structured in this way, it is long-standing legal policy that one who leaves their property with a seller bears the risk of that intermediary's insolvency or financial downfall.

Rules governing transfer and priority in a modern market economy necessarily require balancing two sometimes incompatible commercial law goals: protection of property and ownership rights and facilitation of marketplace transactions through negotiability principles.[83] According to Professor Schroeder, an owner's relinquishment of possession or control to another requires that we give preference to negotiability principles so as to prefer subsequent transferees who take from the person in possession or control over owners, thereby encouraging market confidence and participation.[84]

Not surprisingly, Professor Schroeder's standpoint is shared by Professor Rogers,[85] as compatible with his thesis that implementation of post-settlement finality is the "...basic policy of ... Article 8"[86]. His finality principle is simply a different way in which to express the idea that transferees from intermediaries should take free of adverse

[81] The term "good faith-buyers" is used here to connote buyers how are worthy of the finality protection provided by the market since they do not have notice of wrongdoings by the selling intermediary or are not colluding with the same. For clarity it should be noted that the term, as used here, does not refer to any statutory definition of good faith and thus does not imply any specific differences as regards level of notice required etc. for achieving good faith-status.

[82] Schroeder: Radical Reform, *supra* note 8 at 495 f.

[83] *Ibid.* at 296

[84] *Ibid.* at 496, where she also explains that her concern for consumer protection previously rendered her in favor of rules promoting the protection of owners' good title, whereas she now is more confident that even rules such as those found in Article 8 provide sufficient consumer protection.

[85] Rogers: Policy Perspectives, *supra* note 57 at 1461 f.

claims in order to ensure the efficient functioning of the securities market. Professor Rogers also posits that a rule that favors market transferees over owners will produce further efficiency gains since it relieves transferees from the burden of having to investigate the intermediary's actual title or rights of alienation.[87]

In a similar vein, Professor Mooney asserts that his proposition for "upper-tier priority"[88] is justified on efficiency grounds.[89] His upper-tier priority thesis yields the same implications as the theses advanced by Professors Schroeder and Rogers, i.e. market transferees should prevail over owners for the sake of efficiency.[90] On the other hand, while Professor Schroeder concedes that unless there were priority for upper-tier actors in the market, interest rates and fees would be higher, she also points out that the opposite might be true, i.e. that priority in the lower-tier could lead to lower interest rates for lending secured by securities accounts, and that which alternative has the most efficient impact on the market as a whole is an unanswerable empirical question.

2.4 Investor/Owner Protection

Economic arguments can be advanced in favor of a legal regime that would award protection to consumers or individual investors. The individual investor is an essential

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[86] *Ibid.* at 1539

[87] *Ibid.* at 1533. Concurring view in Official Comment 10 to § 8-102.

[88] Mooney: Beyond Negotiability, *supra* note 10, Part V. A. at 379 ff. Professor Mooney's article was written before the implementation of the current Article 8. In his article he proposes a new system for deciding priority disputes in the IHS, which in large part resembles what later became the rules in Part 5 of Article 8. Mooney's basic proposition is that upper-tier claimants always should prevail over claimants on a lower tier, which means that a holder in the IHS only can look to its intermediary for the benefits of its securities.

[89] See *ibid.* in part V. A. b. at 386 ff., where he argues that lower-tier claimants are able to avoid or reduce losses at the lower cost, since they have the nearly costless option of selecting a reliable intermediary. He also states that the ability to choose one's intermediary is the best tool for market discipline available to the parties. Finally, he rejects monitoring of intermediaries and loss allocation to the party most likely to bring about innovation in the market as not inductive towards efficiency gains since that would be prohibitively expensive and the results too uncertain.

[90] Schroeder: Radical Reform, *supra* note 8 at note 344

part of the securities market and market efficiency requires legal rules that encourage investors to enter the market. Although this is typically accomplished by rules that ensure that the public has faith in the integrity of the market, rules protecting the investors' ownership in potential disputes would provide a complementary incentive.[91]

Consumer or investor protection might also be justified on paternalistic grounds.[92] There is typically an enormous divergence in wealth and sophistication between the average investor and his or her intermediary, warranting legislative intervention to redress the balance, not just through regulation of securities intermediaries, but also through recasting the substantive rules governing rights and duties in the IHS in favor of customers.

One might also favor protection of owners on moral grounds, i.e. that it is simply wrong for a legal system to deprive owners of their property so easily. Wrongful or inefficient behavior should not be encouraged and there is no moral justification requiring the owner to bear the loss when his or her intermediary proves to be less than reliable. The same argument can be made in cases where the intermediary becomes insolvent. Even though there may be no malfeasance or negligence on part of the intermediary in this case, it is difficult to come up with convincing moral arguments as to why other creditors should be awarded the value of the owner's property.

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[91] *Ibid.* at 491
[92] *Ibid.* at 493

2.5 *The Value of Secured Credit*

Re-pledge is an aspect of the long-standing institution of secured credit. The pledge is in fact the most ubiquitous device for providing collateral to a creditor, well-known to Roman law.[93]

Notwithstanding its age and ubiquity, secured financing continues to be the object of prolific scholarly debate, the central question today being whether it is efficient.[94] It has been argued that the traditional priority accorded secured creditors over other creditors should be abolished, or at least limited.[95] Under these proposals, the secured creditor would, on the debtor's insolvency, be deprived of the priority it bargained for, and the value of the collateral (or some portion of it) would instead be applied to satisfy the claims of all creditors, or particular categories of vulnerable or non-adjusting creditors.

Different arguments have been put forward to support the efficiency gains that would supposedly be created by these subordination proposals. Professor LoPucki suggests that the subordination of secured claims to tort claims would lead to more careful behaviour by debtors and a consequential reduction in the amount of injury they

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[93] Flint, Jr., G.L., "Secured Transactions History: The Fraudulent Myth" (1999) 29 N.M.L. Rev. 363 at 365

[94] Schwarcz, S.L., "The Easy Case for the Priority of Secured Claims in Bankruptcy" [hereinafter Schwarcz: The Easy Case] (1997) 47 Duke L.J. 425 at 426 and in note 1, in which he provides a long list of important articles on this subject.

[95] See Harris, S.L. & Mooney, Jr., C.W., "Measuring the Social Costs and Benefits and Identifying the Victims of Subordinating Security Interests in Bankruptcy" [hereinafter Harris & Mooney: Social Costs] (1997) 28 Cornell L. Rev. 1349 at 1351 ff., where they relate the subordination proposals of L. LoPucki and L. Bebchuk & J. Fried and notes 2 and 3 with references to those works. Professor LoPucki argues for subordination of secured creditors in relation to tort claimants. Professors Bebchuk & Fried suggest two alternative schemes: total subordination or subordination of a statutorily decided fraction of the secured claim. See also Schwarcz: The Easy Case, *supra* note 94 at 427 where he refers to E. Warrens' proposal for setting aside a portion of the debtors' collateral for unsecured creditors and note 3 with a reference to Professor Warren's work.

cause.[96] If secured creditors were forced in effect to carry some of the costs of these torts, they would in turn have a stronger incentive to closely monitor their debtors, thereby also contributing to safer operations.

Professors Bebchuk and Fried suggest that the subordination of secured debt would lead to the internalisation of risk and to a more efficient use of a debtor's assets.[97] Their numeric model, the details of which are beyond the scope of this paper, leads them to conclude that activities that are inefficient would not be undertaken if secured credit were subordinated since the additional creditor risk, due to subordination, would lead to higher costs for credit. This would ultimately make inefficient projects prohibitively expensive.

The advocates for secured credit begin from the basic assumption that subordination of secured debt would materially reduce the amount of credit available to distressed debtors, since creditors would deem it too risky to extend credit or would only agree to lend a lesser amount.[98] Professor Schwarcz builds on this assumption to argue that secured financing benefits all creditors by ensuring liquidity for debtor enterprises.[99] According to Professor Schwarcz since illiquidity is one of the leading reasons for business bankruptcies, access to increased capital through secured credit means that debtors are more likely to be able to generate more income with which to repay their indebtedness to all creditors.

Other commentators have argued that we need to take account of considerations in addition to economic efficiency in assessing the institution of secured credit. Professor

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[96] Harris & Mooney: Social Costs, *supra* note 95 at 1352
[97] *Ibid.* at 1361 ff.
[98] *Ibid.* at 1356 f.
[99] Schwarcz: The Easy Case, *supra* note 94 at 444

Woodward, for example, notes that awarding priority to secured creditors implicitly raises issues of distributional justice.[100] He argues that enhanced efficiency may come at the cost of the fairness of the distributional scheme among creditors and that distributional fairness is an equally valid consideration in establishing sound policy.

Turning to the specific issue of the efficiency and fairness of providing Secured Parties with a statutory right to re-pledge, a right of re-pledge is apparently justified on the theory that it enhances the efficiency of the securities markets by creating larger pools of collateral and thus providing credit at lower cost.[101] One could as legitimately argue that re-pledge is distributionally and morally unsound, for maternalistic reason in view of the informational disparity between investors and intermediaries, as well as because of the inherent injustice of transferring wealth to powerful market place actors at the expense of the individual investor.

These policy issues will be revisited later in the paper. The next section discusses the ownership rights that Part 5 of Article 8 actually provides to investors and how re-pledge transactions should be characterized.

3. PROPERTY RIGHTS AND RE-PLEDGE

The revisions to Article 9 that make re-pledge the default rule only affect cases where the original pledge from the Pledgor to the Secured Party is 'hard', i.e., where the securities are transferred from the Pledgor's account so that he or she is no longer an entitlement holder. If the Secured Party is a securities intermediary, it will then no longer be under the obligation imposed by Section 8-504 to obtain the Pledgor's consent before

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[100] Woodward, Jr., W.J., "The Realist and Secured Credit: Grant Gilmore, Common-Law Courts and the Article 9 Reform Process" (1997) 82 Cornell L. Rev. 1511 at 1511 f.

creating security interests in the collateral. The discussion in this section assumes that the original pledge was hard.

3.1 Notions of Ownership and Property Rights

It should already be apparent that 'ownership' of a securities entitlement in the IHS does not carry with it all the incidents traditionally and colloquially associated with property rights. This section therefore begins with an overview of how notions of property and ownership are defined.

Our understanding of property has changed over the years and the more traditional as well as the more recent view will be described, starting with the former.

First, a note about terminology: Property theorists are in disagreement as to whether a 'thing' is significant for the concept of property or whether the term 'interest' or something similar is more appropriate. Certainly, to the extent that the term 'thing' is taken to denote the object in question, the term may not always be accurate. Moreover, 'thing' may be a somewhat inappropriate term when discussing ownership of intangible property. Nonetheless, 'thing' is used in this paper to describe the object of ownership, but care is taken to ensure that this does not create confusion.

3.1.1 The Traditional View of Property: A Right in Rem

Historically, property rights have been regarded as denoting a relationship between a person and a certain thing (i.e. the right is *in rem*) giving that person the presumptive right to exclude all other persons from that thing.[102] Property rights are thus

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[101] Johnson: Derivatives, *supra* note 29 at 969

[102] Merrill, T.W. & Smith, H.E., "What Happened to Property in Law and Economics" [hereinafter Merrill & Smith] (2001) 111 Yale L.J. 357 at 360

traditionally separated from *in personam* rights, since the latter attach to persons regardless of any relationship to a thing and are good only against a few, defined persons, not the world at large.[103]

In practice, this means that the person designated as the owner has the right to physically hold the object to which the interest relates and to control the legal rights attached to the interest.[104] A complete property interest has thus been defined as an interest that provides the holder with at least three incidents: possession, enjoyment and alienation.[105] This exclusionary aspect of a property right is promoted by the right of possession, since it is easier to exclude others from the enjoyment of a thing that one has in one's possession and control,[106] by the right of enjoyment since this ensures that the owner can use the object and receive the benefits attached to the property interest,[107] and by the right of alienation since this enables the owner to sell, pledge or otherwise reap the economic value of the property interest.[108]

3.1.2 The Bundle of Sticks

In contrast with the traditional view, a new school of property theory has emerged, largely as a result of the law and economics movement of the 1960s and 1970s.[109] Property, it is argued, is simply a collection of rights to carry out certain actions

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[103] *Ibid.*

[104] Schroeder: Radical Reform, *supra* note 8 at 367

[105] *Ibid.* at 367 and note 183. Schroeder denotes this view of property as "Hegelian".

[106] Harris, S.L. & Mooney, Jr., C.W., "Symposium on the Revision of Article 9 of the Uniform Commercial Code: The Politics of Article 9: A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously" [hereinafter Harris & Mooney: A Property-Based Theory] (1994) 80 Va. L. Rev. 2021 at 2048

[107] Schroeder: Radical Reform, *supra* note 8 at 368

[108] *Ibid.* in note 183

[109] Merrill & Smith, supra note 102 at 365. For extensive discussions about this view on property see also Penner, J.E., "The "Bundle of Rights" Picture of Property" [hereinafter Penner] (1996) 43 U.C.L.A. L. Rev. 711 and Schroeder, J.L., "Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of

with respect to a particular resource.[110] Under this view, the traditional *in rem* character of property rights has been largely displaced. Ownership consists in a collection of personal rights that the owner has against all others, who have correlating duties not to interfere with the owner's rights.[111] The metaphor of a "bundle of sticks" is commonly used to describe those rights.[112]

In other words, under the bundle of sticks-theory, a property right consists of a list of permitted uses accorded by the state.[113] Since this list can be different for different things, it can be argued that property loses its distinctive qualities and its essence under the bundle of sticks-approach.[114] The rights of the owner are to be seen in relation to the rights of other persons.[115] The content of the rights and any assertion as to their weight can be different depending on the other party concerned since the bearer of the rights is the individual owner and not the thing that he or she owns.

Any kind of right can be inserted into the bundle of sticks. These rights need not be different from any contractual or other type of right that a person can have; the several interests in the bundle are distinct and can be separated and disposed of, without rendering a person's remaining interests less valid.[116].

Property" [hereinafter Schroeder: Chix Nix] (1994) 93 Mich L. Rev. 239. These articles all include numerous references to other works concerned with the concept of property.

110 Merrill & Smith, *supra* note 102 at 367

111 Penner, *supra* note 109 at 712

112 Plank, T.E., "The Outer Boundaries of the Bankruptcy Estate" [hereinafter Plank] (1998) 47 Emory L.J. 1193 at 1209 f.

113 Merrill & Smith, *supra* note 102 at 366

114 Schroeder: Chix Nix, *supra* note 109 at 240

115 Penner, *supra* note 109 at 725

116 Schroeder: Radical Reform, *supra* note 8 at note 183

3.1.3 Ownership as a Relationship to a Distinct Thing

Ownership and property rights have traditionally been associated with one distinct, identifiable thing[117] on the theory that if the rights of owners are to be practically identifiable, the rights must be related to a specific item of property. How would the owner otherwise be able to realize his or her right to exclude others, and conversely, how would others know not to interfere?[118]

The same relation to a distinct thing arguably must also be possible under a bundle of rights theory.[119] If a person consults a list of permitted uses and finds that he or she is allowed to sell object X and keep the proceeds, he or she is nevertheless unable to capitalize on this right if it is impossible to distinguish X from objects W, Y and Z.

3.1.4 Why Is 'Property' Important?

The bundle of sticks-conception of property is currently seen as the norm in Anglo-American scholarship, but it is not uncontested and the traditional conception has its advocates as well.[120] Regardless of the relative merits of the two theories, there seems to be some consensus that the core rights to possession, enjoyment and alienation associated with the traditional theory are present also in the bundle of sticks-metaphor, as

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[117] Official Comment 2 to § 8-503

[118] Identification of a thing is also a very important aspect of the law relating to tracing and following of things and rights in things. See in this respect Smith, L.D., *The Law of Tracing* (Oxford: Clarendon Press 1997) [hereinafter Smith: Tracing] at 104 and section 3.2.3 below.

[119] This viewpoint finds support in the UCC in the rules concerning the financing statements that must be filed when creating security interests (a species of property) by registration. This is governed by Section 9-402 which states that the statement must contain a description of the collateral. If this description is too vague, the security interest is invalid. In insolvency, when resources are scarce, a secured party is hoping to extract the property which relates to his interest and thereby escape the communal sharing and loss that general creditors will most likely sustain. If that property is indistinguishable, there seems to be no alternative to having the secured party share its value with others who have similar interests in similar non-distinct property.

different sticks in that bundle.[121] The reasons why are revealed by a review of the reasons for the creation of property as a concept.

For the traditionalists[122] the main *raison d'être* for property is to provide "a basis of security of expectation regarding the future use and enjoyment of particular resources."[123] Industrious efforts to preserve, improve, and exploit the full value of resources would not be undertaken if the owner could not be sure to enjoy the fruits of those efforts. Property rights are likewise seen under the traditional view as the foundation for a system of economic exchange.[124] The right to alienation enables property owners to exchange an asset for its economic equivalent and the allocation of distinct property rights ensures orderliness in the exchange process. Under the traditional view, property is thus a tool for achieving economic development.

The more recent scholarship sees the allocation of resources as the purpose of the institution of property, and, as such, property is regarded primarily as a process for resolving conflicts between competing interests in the same resource.[125] The newer theorists have also focused on contractual exchange, in the sense that the allocation of resources by the property system provides the backdrop for contractual exchange. Law

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[120] See i.a. Merrill & Smith, *supra* note 102; Penner, *supra* note 109 and Schroeder: Chix Nix, *supra* note 109

[121] See Penner, *supra* note 109 in part II.G at 754 ff., where a number of incidents of ownership under the bundle of sticks-metaphor are listed. The main difference from the traditional property view seems to be that no one specific aspect is distinctive or constitutive of the property right. See also Plank, *supra* note 112 at 1193, who makes less of a choice between the two conceptions but nevertheless lists the rights to possess, sell and use as parts of ownership.

[122] William Blackstone, Adam Smith and Jeremy Bentham represent the traditionalists for current purposes. See Merrill & Smith, *supra* note 102 at 360 ff. where they recount for these authors' views on property.

[123] *Ibid.* at 361

[124] *Ibid.* at 362

[125] *Ibid.* at 369 f.

and economics theorists see the choices concerning allocation as based almost solely on economic efficiency criteria, but others see non-economic criteria as also relevant.[126]

The common thread in the old and new scholarly work is the idea that property as a legal construct mainly serves to provide a framework for the exploitation of economic values. Whichever conceptual notion one prefers, property must still have some basic attributes that enable it to be put to such economic use. The three traditional core attributes, possession, enjoyment and alienation, are all instrumental in the economic exploitation of things and their value. Even if the bundle of sticks-approach sees none of these attributes as essential, they are at least relevant to the concept of property. Commentators have also observed that the lay understanding of property continues to correspond better to the traditional view of property, in which these features are regarded as essential.[127]

The analysis of property rights in the IHS that follows here adopts the traditional view as its departure point. We shall see that the IHS in many respects is more in tune with the bundle of sticks-metaphor, making it even more appropriate to use the traditional conception of property, that contains the three core elements previously mentioned, as the baseline theory for comparison.

3.2 Property Rights under Part 5 of Article 8

The effect of a re-pledge is to transfer part of the property owner's exclusive right of alienation to the Secured Party, since the Secured Party becomes entitled to alienate the collateral not as an agent for the Pledgor, but as principal for its own account.

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[126] *Ibid.* at 381, where they recount the concept of property put forward by Calabresi & Melamed. These two economic scholars have interestingly enough denoted the use rights that constitute property as 'entitlements', which sounds familiar if one recalls the terminology used in the IHS.

Consequently, it is questionable if a holder in the IHS can be regarded as the 'owner' of anything, in the traditional sense of property ownership. Indeed, the rights held by customers have been described as a "...*sui generis* form of property interest..."[128]. The following sections explore the incidents attached to this unusual type of a property interest under Article 8.

3.2.1 Rights under Section 8-503: pro rata sharing

Section 8-503(b) spells out one unique aspect of the 'property' right of a holder of a securities entitlement: it is a pro rata right shared with the other customers of the intermediary. Under traditional property theory, ownership rights are generally viewed as exclusive rights that by their very nature relate to identifiable things (be they tangible or not). Section 8-503(b) abandons that aspect of the property concept, the justification being that the practicalities of the operations of the market renders identification impossible.[129]

Pro rata sharing is not something new. Prior Article 8 was also drafted on the assumption that the system of holdings with intermediaries makes it impossible to identify which securities belong to which holder. The intermediaries' aggregate holdings were therefore denoted as a 'fungible bulk', in which each holder had a proportionate ownership interest.[130] The same idea is reflected in the bankruptcy provisions on broker

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[127] See Schroeder: Chix Nix, *supra* note 109 at 271 and Plank, *supra* note 112 at 1193
[128] Rogers: Policy Perspectives, *supra* note 57 at 1496
[129] Official Comment 2 to § 8-503
[130] Schroeder: Radical Reform, *supra* note 8 at 333

insolvencies[131], under which customers share rateably in proportion to their net equities in the aggregate pool of property held by the broker on account of its customers.[132]

The fact that a customer has no claim to any particular security may seem uncontroversial. However, a right of pro rata-sharing is quite distinct from a property right that allocates ownership to a distinct identified thing. One major economic advantage of traditional ideas of ownership is the owner's presumptive right, if an asset is deposited with a third party, to extract that *whole* asset from the third party's estate in the event of bankruptcy. Under this approach, the owner's position cannot be prejudiced by how many other owners have also deposited their assets with that third party. The economic substance of an owner's property rights in the IHS in bankruptcy is therefore different from the traditional property interest. Conversely, the sharing principle can also work to a particular customer's advantage relative to the traditional *in rem* approach. If a shortfall of customer securities were instead allocated to a particular customer's holdings, he or she might retain less of his or her initial investment than under the sharing principle.

3.2.2 Rights under Section 8-503: Adverse Claims

Subsections (d) and (e) of Section 8-503 set out the limited circumstances in which a holder is empowered to enforce its 'property interest' against a purchaser of a financial asset acquired from a securities intermediary; these special rules override the

[131] See Securities Investor Protection Act of 1970: 15 U.S.C.S., §§ 78aaa – 78lll (2002) and subchapter III of chapter 7 of the Bankruptcy Code: 11 U.S.C.S. §§ 741 – 752 (2002)

[132] Kettering, *supra* note 11 at 86. The specific rules of pro-rata sharing do not apply to bankruptcies involving entities not governed by SEC regulations. In such cases, the Pledgor's right to recover securities from the estate depends on the establishment of a property right in particular securities within the pool.

general adverse claim cut-off rules for the IHS set out in Sections 8-502 and 8-510.[133] Under the traditional theory, the hallmark of a property right is the right to exclude all others from enjoyment of that property. A corollary of that right is that the owner should be able to reclaim his or her property from anybody who comes into possession or control of it against the owner's will. However, the ownership right cannot be absolute since the workings of a modern economy require that competing transferees be, to some extent, protected. It is this clash between protection of property and promotion of market negotiability that these sections of Article 8 seek to resolve.

The negotiability rules in 8-503(d) and (e) are highly purchaser-friendly. Subsection (d) makes it clear that an owner can assert rights against any party other than the intermediary only when the intermediary is insolvent. If a solvent intermediary does not have sufficient securities to satisfy a customer's demand, the customer's remedy is to compel the intermediary to acquire what is lacking.[134] Even in insolvency, the owner may lose to a purchaser by virtue of the rules in subsection (e) which protect a purchaser who gives value and obtains control, provided the purchaser is not in collusion with the intermediary in violating the latter's obligations under Section 8-504.

In the view of some analysts, the barriers for asserting adverse claims have been set too high for entitlement holders.[135] Facciolo describes the barrier in Section 8-503 as "...virtually insurmountable..."[136] and considers the justification provided in the Comments to be "...particularly weak."[137]. Professor Schroeder is troubled by the fact

[133] Official Comment 2 to § 8-503. For more on these general adverse claim cut-off rules, please see section 3.3.1 below.
[134] *Ibid.*
[135] See Schroeder: Radical Reform, *supra* note 8 at 299 f. and Facciolo, *supra* note 28 at 655 f.
[136] Facciolo, *supra* note 28 at 655
[137] *Ibid.*

that even under the test in 8-503(e), purchasers with actual *knowledge* of prior interests are protected as long as they are not acting in actual collusion with the intermediary. The general cut-off rules protect purchasers who are without notice, whereas the test in 8-503(e) centers on collusion. The general rules in Section 8-502 and 8-510 cut off the owner's rights if the purchaser has notice of the owner's interest. Section 8-503(e), however, states that for the customer to prevail the transferee must be in collusion with the Secured Party "in violating the securities intermediary's obligations under Section 8-504". According to the Comments, this means that the transferee must be "...affirmatively engaged in wrongful conduct..."[138].

In Professor Kettering's view, cases can and will occur where a transferee with notice of an adverse claim by a customer would still not be found to be in collusion with the intermediary, and vice versa.[139] Professor Rogers, on the other hand, finds it "...difficult to devise a hypothetical in which it would be clear that different outcomes would be produced..."[140] under the notice and collusion standards. However, his analysis focuses on justifying the collusion standard as the end-product of a drafting process involving a large number of people with divergent views. This presumably is a different way of saying that the collusion standard resulted from a compromise,[141] an explanation that is not very useful for understanding the difference, if any, between the notice and collusion standards.

The object of the collusion standard in Section 8-503(e) is to promote the finality principle. According to the Comments, it is based on the long-standing policy that

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[138] Official Comment 3 to § 8-503
[139] Kettering, *supra* note 11 at 163
[140] Rogers: Policy Perspectives, *supra* note 57 at 1536
[141] *Ibid.* at 1530 ff.

purchasers should not be required to bear the burden and loss resulting from wrongful behavior by their sellers since such a liability would create transactional insecurities disadvantageous to all market participants.[142] Relatedly, it is argued that investors as a collective will benefit from a high standard, since it promotes the sound and efficient operation of the market.[143]

These justifications notwithstanding, Article 8 clearly encroaches deeply on traditional property rights. As the group of purchasers against which the owner can assert his or her right is diminished, so is the economic substance of the property right. The right to peaceful, exclusive enjoyment, presumptively good against the world, is curtailed and exchanged for a personal claim against an intermediary.

3.2.3 The 'Nontraceability Thesis

According to the Comments to Article 8, Part 5, "[t]he 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."[144]. Professor Kettering calls this the "Nontraceability Thesis".[145]

The term 'tracing' is used in the Comments and by Professor Kettering to describe the inherent right of an owner to retain his or her ownership in a thing after its unauthorized transfer and to assert ownership in the thing against the transferee. This does not correspond to the usual meaning of the term tracing. Tracing is more correctly used to describe a situation where "...for certain legal purposes, one asset stands in the

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[142] Official Comment 3 to § 8-503
[143] *Ibid.*
[144] Official Comment 2 to § 8-503. The Official Comments to Part 5 of Article 8 restate this position in a number of instances, see e.g. Official Comment 3 to § 8-502 and Official Comment 5 to § 8-501.

place of another. A claim which could have been made in relation to the original asset is allowed in relation to the new asset."[146]. In the immediate context, tracing would refer to the issue of whether the Pledgor's ownership rights are transferred to the proceeds received by a Secured Party on alienation of securities.

What the Commentators and Kettering call 'tracing' is in fact more correctly called 'following'.[147] Professor Smith defines following as "...a matter of identifying a thing, usually as it is transferred from one person to another. Following, therefore, is always concerned with the *original thing*, and it can bring into the picture a *new person*."[148] When tracing is concerned, on the other hand, "...the focus is not on the original thing, but the substitute thing acquired by the holder. Tracing, therefore, always brings into the picture a *new thing*, acquired by the *original holder*."[149]. Even though the Comments and Professor Kettering's criticisms thereof confuse the two concepts, in order to stay true to these sources, their use of the word tracing will be respected in the discussion that follows, even though it is a misnomer.

According to the Comment to Section 8-502, "[b]ecause 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 the parties who hold through intermediaries is described."[150]. Professor Kettering construes this as abolishing tracing altogether in the IHS, with the result that a purchaser (including a pledgee) acquires full title not because of the adverse claim cut-off

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[145] See Kettering, *supra* note 11 in Part III.B.2.a at 91 ff., where he discusses the issue in great detail and length. The following is merely a brief summary.

[146] Smith: Tracing, *supra* note 118 at 6

[147] *Ibid.* and Bogert, G.T., *Trusts - Hornbook Series, Practitioners Edition*, 6th ed (St. Paul: West Publishing Co, 1987) [hereinafter Bogert: Trusts] at § 161.

[148] Smith: Tracing, *supra* note 118 at 8 (emphasis in original)

[149] *Ibid.* (emphasis in original)

rules but solely because of the Nontraceability Thesis.[151] The result of this interpretation is that a pledge in which the pledgee takes control by becoming the entitlement holder of the securities entitlement (a 'hard' pledge) would extinguish the Pledgor's property right in the entitlement. If this is true, the relationship should no longer be regarded as a pledge at all, but rather as a sale.[152] The Pledgor's property right would be altogether terminated and he or she would be left with only a personal claim against the Secured Party for the consideration of the 'sale', i.e. the return of securities in the equivalent amount.

The result is unorthodox if Professor Kettering is correct. A pledge by definition is not a transaction in which the owner relinquishes residual ownership and such a result would presumably be contrary to the general expectations of pledgors.[153] For this reason, and the fact that the SEC's rules on re-pledge would be unnecessary if the Nontraceability Thesis were accepted, Professor Kettering rejects it.

Nonetheless, Professor Kettering makes a strong case for his interpretation and it fits nicely with the tone of the Comments. It is apparent that the overriding policy goal is to provide buyers with good title and the market with rules that will ensure the smoothest operation. The emphasis is placed on the integrity of the intermediaries on the theory that sufficient investor protection is provided by other law.[154] Moreover, Professor Rogers, the drafter, takes the view that commercial law rules can do nothing to eliminate or alleviate the risk of intermediary wrongdoings unless the finality principle is given lesser importance.[155] Professor Rogers nonetheless rejects Professor Kettering's interpretation

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[150] Official Comment 2 to § 8-502
[151] Kettering, *supra* note 11 at 112 f.
[152] *Ibid.* at 113
[153] *Ibid.* at 117
[154] Official Comment 2 to § 8-511
[155] Rogers: Policy Perspectives, *supra* note 57 at 1520 ff.

mostly, it seems, because in runs contrary to long-standing tradition, but also because he believes that such a change would not benefit owners as a group, since if one owner (i.e. the investor) wins, then, on the opposite side, another owner (i.e. a purchaser) simultaneously loses.

Professor Mooney repeatedly takes the view that a customer's ultimate protection lies in his or her choice of intermediary.[156] As long as the intermediary stays solvent or commits no wrongs, the customer need not worry about the existence of property or tracing (following) rights. This view is also prevalent in the Comments and in Professor Rogers' works. In effect, the customer has agreed to rely on the intermediary's integrity and anything that is good for intermediaries, e.g. the Nontraceability Thesis, is consequently good for customers as well, since it reduces the risk of failure.

Not all Secured Parties in re-pledge transactions are securities intermediaries. In the OTC derivatives setting, the Secured Party may be a derivatives dealer or a regular commercial entity. The Secured Parties' counterparties in such transactions may have greater ability and opportunity to make assessments of the reliability and integrity of the Secured Party than customers of securities intermediaries, since they are likely to be more sophisticated. Still, the fact that parties to OTC derivatives transactions frequently require the obligor party to give collateral demonstrates that they are not content to rely solely on the integrity of the counterparty.

The confusion of the following and tracing concepts that has been described above may be of minor concern since it seems evident that the lawmaker intended the transferee to prevail for policy concerns unrelated to the practicalities of tracing or following. Leaving this point aside for the moment, the statements in the Comments on tracing have something in common with following principles.. The Comments adopt the position that tracing (i.e. 'following') is overridden because the IHS is structured in a way that makes it impossible to identify a specific security as it travels through the IHS. Moreover, according to the Comments, security entitlements as such are not being transferred. A sale or creation of a security interest is rather the extinction of one person's right and the creation of a new right owing to someone else.

The fact that 'tracing' is impossible as a practical matter would seem to produce the same result as if following had bee explicitly abolished in law. However, in the case of mixtures, traditional property rules can provide a fictional or legal means of identification of the relevant thing when factual identification becomes practically impossible.[157] These fictional rules enable a claimant to follow his or her asset into a mixture of assets in which the separate contributions are factually indistinguishable.[158] If these rules on following into fungible mixtures were applied, by analogy, to securities intermediaries' customer accounts, the right to follow would not be lost simply because it is impossible to identify which security was originally purchased for which customer. Contrary to the view purported in the Comments, the customer would be allowed, by the use of some fictional rule, to designate a certain security as 'his' or 'her' own. Whether the customer would then be allowed to assert a proprietary right in that security would depend on the nature of the competing interest and the content of the applicable priority rules.

Following as such is a purely technical exercise, used to determine whether or not a thing can still be identified after a transfer to a third person, i.e. whether the thing held

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[156] Mooney: Beyond Negotiability, *supra* note 10 in Part V.A.1 at 381 ff.
[157] Smith: Tracing, *supra* note 118 at 73 and 77 ff.

by that person is the 'same thing' as the thing in which the previous owner claims a right. That mechanical issue is distinct from the policy question of whether or not the claimant can assert rights against the third party, assuming that identification has been successful.[159] Section 3.3.2 below will show that priority disputes, as regards re-pledge, are generally won by the Re-pledgee.

The statements in the Comments discussed here have therefore probably been made to further the policy that transferees and institutional market participants should be protected, i.e. that negotiability should prevail over original ownership. However, instead of openly stating that transferees almost invariably take free of adverse claims, the Comments disguise this result in the language of tracing, and even then misuse the concept.[160] Moreover, as Professor Kettering has shown, the Nontraceability Thesis may bring unwanted consequences unintended by the drafters.

Traditionally, following was thought to be impossible when the object at issue was intangible and principles for following are used to solve situations involving intangibles only by analogy.[161] However, analysts today acknowledge that the distinction is blurred, and that it becomes even more difficult to make when the intangible is itself a proprietary right in an intangible.[162] The Comments to Article 8, however, show little concern for conceptual rigor. As long as the policy goal of providing buyers and secured parties with protection against adverse claims is achieved, it is seems not to matter

[158] *Ibid.* at 71
[159] *Ibid.* at 10
[160] Compare in this respect my observations in sections 3.3.2 and 3.4.1 below about the 'honesty' of Part 5, Article 8.
[161] Smith: Tracing, *supra* note 118 at 68
[162] *Ibid.*

whether the mechanism used to achieve that end rests on the concept of 'tracing' or 'following' or property rights or priority rules.

Viewed as an issue of priority, an analogy can be made to a priority contest between trust beneficiaries and transferees from a wrongdoing trustee under an unauthorized transfer.[163] This analogy is pertinent since the trustee, like the securities intermediary, appears to the world to be the owner of property that in fact belongs to someone else. Principles of negotiability and market protection require that purchasers from such sellers generally take the thing free from the claims of the true owners. Consequently, even though tracing and following are well established proprietary remedies for trust beneficiaries, their availability is often blocked by the *bona fide* purchaser rule.[164] The same is even more true for Pledgors in the IHS since under Article 8 they stand to lose almost every priority contest, absent evidence of actual collusion. This excursion into priority rules demonstrates once again that the drafters of Article 8 have elected to place finality and negotiability concerns over the property and the interests of owners. This seems to be the prevailing trend in US commercial law generally, with the result that 'ownership' has come to lose much of its significance as a prima facie method for resolving priority disputes.[165]

Even though the Comments favor the Nontraceability Thesis, Professor Kettering is probably right in concluding that it should be rejected and that the courts most likely would disregard it.[166] Application of the Nontraceability Thesis would make the rules on re-pledge superfluous; after all, if the Secured Party already is the 'owner' of the

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[163] Bogert: Trusts, *supra* note 147 at § 165
[164] *Ibid.*
[165] Smith: Tracing, *supra* note 118 at 90, in note 95
[166] Kettering, *supra* note 11 at 139

securities, it can do with them whatever it wants. Moreover, it would be psychologically disastrous to tell the millions of investors who fuel the securities market that a pledge in fact involves the risk of total loss of their ownership rights. One might even speculate that it is this fear that held the drafters back from making a more direct or explicit statement of the intended legal result.

In summary, the *sui generis* form of property interest awarded to customers in the IHS lacks a number of the traits of a traditional property right to the extent that one must question whether the customer's property right survives the initial pledge at all. It is perfectly logical to make re-pledge the default rule in such a legal environment.

3.3 Characterization as Secured Transaction or Sale

3.3.1 Property Rights in 'Re-pledgeable' securities

The question to be addressed in this section is the extent to which a customers' ownership and property rights are affected by the fact that the Secured Party is at liberty to re-pledge the customer's securities for its own account. That question invokes the possibility that a 'hard' pledge in fact should be characterized as a sale.

The Nontraceability Thesis has been put forward as a reason why a hard pledge in the IHS should in fact be characterized as a sale. However, the issues raised by the Nontraceability Thesis are separate from re-pledge since the harsh results produced by the former are present even in an ordinary pledge that is not followed by a re-pledge. Conversely, the question of correct characterization is always relevant in a pledge in which re-pledge is contemplated, even if the Nontraceability Thesis is rejected.

Under the traditional view, ownership carries with it a number of rights that belong to the owner exclusively, including the right to make decisions regarding the use of the relevant thing, e.g. whether it be pledged or not.[167] Moreover, a security interest gives only a limited right to the collateral to the Secured Party. The Pledgor normally is seen as retaining the right to make decisions about the use of collateral even after granting a security interest, at least until the Pledgor's default.

When securities are given as collateral in the IHS, the UCC rejects the traditional view and gives the Secured Party a right to use them to secure its own borrowings. The Pledgor thus loses some of the traditional incidents of ownership.

An important incident of the traditional concept of ownership in a secured transactions context is the pledgor's right to redeem the collateral by paying the debt secured by the collateral; redemption normally extinguishes the Secured Party's security interest and the Secured Party becomes obligated to return the collateral (unencumbered).[168]

Whether a transaction in which property rights are being transferred should be characterized as a sale or a secured transaction depends on the type of property right the pledgor retains in the transaction.[169] Only if that interest is truly meaningful would it be appropriate to talk of a secured transaction. Professor Schroeder has analyzed the correct characterization of a repurchase agreement and she concludes that the fact that a repo seller is without a right to redemption makes the repurchase agreement a sale.[170]

[167] For the definition of 'property', as used in this paper, please see section 3.1 above.

[168] Plank, *supra* note 112 at 1232

[169] Schroeder, J.L., "Repo Madness: The Characterization of Repurchase Agreements under the Bankruptcy code and the U.C.C." [hereinafter Schroeder: Repo Madness] (1996) 46 Syracuse L. Rev. 999 at 1017

[170] *Ibid.* at 1021

According to Professor Schroeder, this same reasoning supports the view that a re-pledgeable pledge remains a secured transaction, since the pledgor retains a right of redemption under Section 9-623.

However, Professor Schroeder's article was written before the 1999 revision of Article 9. In her view, Prior Section 9-207, which prohibited impairing re-pledges, gave the pledgor a sufficiently meaningful right of redemption for the original pledge to count as a secured transaction. Her analysis also relied on the fact that even though re-pledge might impair the right to redeem in practice, the secured party had no *right* to create such an impediment.[171]

Professor Schroeder's analysis might be different today in light of the revisions to Section 9-207. The pledgor's right to redeem may be rightfully impaired under current law and the right to redemption may have become so insubstantial that the transaction amounts effectively to a sale.

The practical effectiveness of a right of redemption is always contingent on the fact that the Secured Party has not misappropriated the collateral so that it is unable to return the collateral once the Pledgor has satisfied the secured obligation. Nevertheless, as long as there are only two people involved, the situation is fairly uncomplicated. But if the collateral has been rightfully re-pledged, the possibility that the collateral cannot be redeemed at the Pledgor's will is much greater. Since a third party, the Re-pledgee, has been granted rights in the collateral, the Pledgor's right to redeem becomes dependent on whether the Pledgor or the Re-pledgee has priority.

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[171] *Ibid.* at 1021

3.3.2 Priority Disputes between Pledgor and Re-pledgee

Priority disputes between a Re-pledgee and the Pledgor are resolved by application of the adverse claim cut-off rules in Article 8. The situation here is one in which the Pledgor is not an entitlement holder of the Secured Party and the general rule of Section 8-502 will therefore apply.[172] Under that Section, anyone who acquires a security entitlement for value and without notice of an adverse claim takes free of that claim.

What constitutes notice of an adverse claim is set out in Section 8-105. Section 8-105 provides that a person has notice in three different circumstances. First, and most obviously, someone who has actual knowledge of an adverse claim has notice.[173] Second, someone who remains "willfully blind" to facts that constitute a significant probability that an adverse claim exists has notice.[174] Last, a party who is under a statutory or regulatory duty to investigate whether an adverse claim exists is deemed to have notice if such an investigation would have established the adverse claim.[175]

The definition of what constitutes an "adverse claim" is set out in Section 8-102 (a)(1). Mere knowledge of the fact that someone other than the transferor has a property interest in the securities does not constitute notice of an adverse claim.[176] It is necessary that the transferor have been acting in violation of someone else's property interest and that the transferee have been aware of that. In other words, a transferee is entitled to

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[172] Kettering, *supra* note 11 at 155

[173] § 8-105(a)(1). See Official Comment 3 to § 8-105

[174] § 8-105(a)(2). See Official Comment 4 to § 8-105: Willful blindness means that someone is aware of facts that indicate that there is a significant probability that an adverse claim exists and, notwithstanding this awareness, deliberately avoids obtaining information that would give him or her knowledge of the adverse claim.

[175] § 8-105(a)(3)

[176] Official Comment 2 to § 8-105

assume that a transferor is acting rightfully, as long as there are no substantial contrary indications to warrant further investigation.

This definition of adverse claim means that when a transfer is not in violation of the Pledgor's property right, the Pledgor does not have an 'adverse claim' in the first instance.[177] The cut-off rules only apply to 'adverse claims', meaning that only such claims as defined are cut off. Professor Kettering nevertheless suggests that even claims that fail to satisfy the statutory criteria for 'adverse' should be treated in the same way.[178] This seems the most sensible result since it is implicit in the drafting that claims below the required level of adversity should not be protected against a Re-pledgee. Anything else would be illogical and contrary to the objective of providing buyers with finality protection.

It follows that in most cases where a Secured Party re-pledges collateral under the new rules of Section 9-207, the Secured Party will not be acting in violation of the Pledgor's rights and will consequently not be committing a wrongful transfer. Consequently, the Pledgor will not be able to assert an 'adverse claim'.

The Comments to Section 9-207 suggest that the Re-pledgee's priority is implicitly consented to by the parties and that this provides further support for disallowing the Pledgor from making any claim against the Re-pledgee.[179] This is based on the theory that participants in the securities markets have expectations and practices that imply that a Pledgor, when pledging securities to a Secured Party, agrees (albeit tacitly) to a later Re-pledgee taking free of any claims of the Pledgor.[180]

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[177] Kettering, *supra* note 11 at 160
[178] *Ibid.*
[179] Official Comment 5 to § 9-207
[180] *Ibid.*

In fact, it seems more reasonable to assume that investors do not expect that 'their' securities can be 'given away' by their intermediary. It possible that re-pledge is so common in the market that investors should reasonably expect that their Secured Parties will engage in re-pledge transactions. However, this does not mean that investors are aware of the adverse priority consequences that follow from re-pledge.

This passage in the Comments is yet another example of the drafters' desire to protect securities intermediaries and their buyers. However, by relying on assertions about market expectations that are at least empirically uncertain the Comments fail to justify the resulting rules. Professor Rogers asserts that Revised Article 8, as compared to its predecessor, is more honest and 'tells it like it is', i.e. that the tenuous position of holders in the IHS is now stated openly in the law.[181] While this goal is commendable, it is questionable whether it has been truly respected.

3.3.3 A Sale – But Then Again Not...

It has already been demonstrated that the Pledgor's traditional ownership rights are diminished by a re-pledge under the UCC. The fact that the UCC's adverse claim cut-off rules are likely to result in the Re-pledgee winning in almost every instance provides further support for the proposition that the transaction between a Pledgor and a Secured Party is most accurately characterized as a sale. Since the Pledgor generally retains little more than a personal claim against the Secured Party, the transaction is more like a sale with a deferred payment in which the buyer's obligation is unsecured.

This characterization arguably applies whether or not the Secured Party actually re-pledges the collateral. The mere fact that the Secured Party is entitled to do so arguably means that the Pledgor has given up so much of his or her proprietary rights as to be more appropriately treated as a general creditor of the Secured Party than an owner of property in the Secured Party's 'possession'. Under this view, the characterization issue is resolved by application of what has been called the "consent to impairment-test".[182] Since the Pledgor is unable to prevent a re-pledge, the initial pledge is in itself a total alienation of the collateral. It would also lead to arbitrary results to have the characterization depend on the subsequent actions of the Secured Party. The need for predictability and clarity require that the parties be able to determine at the outset if they are engaging in a sale or a secured transaction.

Professor Kettering points out that a secured transaction contemplating re-pledge is troublesome from a conceptual point of view since the Pledgor probably will continue to consider him- or herself as the owner of the collateral.[183] The problem is that the Secured Party, at the same time, is able to use the full value of the collateral for its own needs, thus acting as 'owner'. This raises the question as to who the owner is and if the Pledgor has sold or merely created a security interest in his property. What are the consequences in the event of the Pledgor's insolvency if the Pledgor's view of the situation is accurate, i.e. if the Pledgor is still the owner. In *United States v. Whiting Pools Inc.*[184], it was held that a bankrupt debtor's estate included any property right of the

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[181] Rogers: Policy Perspectives, *supra* note 57 at 1537

[182] Kettering, *supra* note 11 at 205 f. Kettering recounts Professor Schroeder's view, which is that the determining factor for the re-classification issue should be whether the Pledgor has consented to re-pledge; and not whether the re-pledge actually is done. Kettering denotes this test the "consent to impairment-test". Schroeder's proposition has been made in the context of repurchase agreements. For current purposes, where the right to re-pledge is statutory, the consent-part of the test would of course be 'substituted' for the affirmative choice in favor of re-pledge that has been made by the legislator.

[183] *Ibid.* at 201

[184] 462 U.S. 198 (1983)

debtor, even if it is economically worthless.[185] Professor Kettering observes that under the law as stated in *Whiting Pools*, a Pledgor's securities would be included in the Pledgor's bankruptcy estate, notwithstanding a re-pledge.

It would be very alarming for Secured Parties and their Re-pledgees if the Pledgor's trustee in bankruptcy was thus entitled to repossess the collateral. The *raison d'être* for allowing re-pledge is to ensure that the Re-pledgee acquires rights that are superior to those of the Pledgor. Re-pledgees would therefore wish to argue that a pledge contemplating re-pledge should be characterized as a sale, so as to be sure to terminate any remaining property interest of the Pledgor.

However, the characterization issue may not be as critical as might be thought from *Whiting Pools*. Professor Plank argues that the *Whiting Pools* court misinterpreted the meaning of the term property in the Bankruptcy Code, in failing to recognize that the term in that context refers to the debtor's interest in a certain thing, and not the thing itself.[186] In the Supreme Court's subsequent decision in *Citizens Bank of Maryland v. Strumpf*[187] Professor Plank argues that the court rejected its previous interpretation of 'property of the estate' and, instead, acknowledged that the debtor's interest in property consisted of its rights therein according to the debtor's agreement with the bank.[188] Professor Plank concedes that the factual circumstances in *Whiting Pools* and *Strumpf* were distinct and that *Strumpf* does not explicitly overrule *Whiting Pools*.[189] He nevertheless argues that the similarities are substantial enough to support the proposition that the debtor's property interest is no larger than its remaining rights under the contract

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[185] Kettering, *supra* note 11 at 202 f.
[186] Plank, *supra* note 112 at 1237 ff.
[187] 516 U.S. 16 (1995)
[188] Plank, *supra* note 112 at 1255 ff.

with the secured party. The estate is consequently unable to assert any rights greater than these.

The outcome in *Strumpf* should provide comfort for worried Secured Parties or Re-pledgees. The Pledgor's estate's ability to upset re-pledge transactions has been curtailed, and even if the pledge contemplating re-pledge is considered as leaving residual ownership rights in the Pledgor, those rights will be subject to the superior interests of Re-pledgees.

To summarize, it is questionable whether the Pledgor retains sufficiently substantial rights after a pledge contemplating re-pledge to still describe him or her as the owner of the collateral. The transaction should therefore be labeled a sale. On the other hand, this characterization was most likely not intended by the drafters of Article 9. There are a number of useful rules concerning secured transactions in Article 9 that would become inapplicable if the transaction were instead a sale. Moreover, the Comments repeatedly emphasize that the holder does have property rights in his or her securities. As Professor Kettering points out, the consent to impairment-test would mean that all transactions governed by the gap-filling rule of Section 9-207(c)(3) would be treated as sales, a result clearly inconsistent with the drafters' intent.[190]

Nonetheless, the foregoing demonstrates that the property rights retained by a Pledgor are quite limited under revised Article 9. It therefore is appropriate to examine the justifications for the revisions and their impact on the interests of Pledgors.

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[189] *Ibid.* at 1258 ff.
[190] Kettering, *supra* note 11 at 206

3.4 Should There Be a Statutory Right to Re-pledge?

This section addresses the question of whether it was warranted for the drafters of the UCC to provide a statutory right to re-pledge in the UCC. The issue will be analyzed from the perspective of the different policy considerations reviewed earlier in section 2, as well as from the viewpoint of coherence with general property norms.

3.4.1 Re-pledge and Property Rights as a Legal Concept

The preceding sections have shown that a default right to re-pledge is in some ways contrary to traditional notions of property rights. This is grounds for criticism only if the preservation of strong property rights brings with it any substantial benefits for investors as a group or to the markets as a whole. These benefits could be conceptual/systemic or more substantive/result-oriented. The result-oriented argument is largely centered on protection of owners' interests when their Secured Party fails and will be discussed below in section 3.4.4.

As regards possible conceptual benefits, preserving traditional property rights for investors would preserve overall coherence with the rest of the legal system. If property rights still receive strong protection in other areas of the law, it would be reasonable to expect that property rights should be similarly protected in the securities setting. This would also be more in tune with the colloquial meaning of property.

However, the revision is in fact consistent with the current thrust of developments in other areas of commercial law. Commentators have shown that the current trend is to favor marketplace alienability or negotiability over the protection of ownership rights.[191] This is not surprising in a market economy where transfers of property are one of the major forces behind the economy. Buyers require some degree of prima facie assurance about the validity of their sellers' power to alienate in order to be willing to enter the market since background investigations are costly and create inefficiencies.

In addition, re-pledge is only one aspect of the general issue of property rights in the IHS. The preceding sections have shown that, regardless of how the particular issue of re-pledge is resolved, providing entitlement holders with strong property rights is not a major concern of the drafters of the UCC. This supports the admittedly defeatist view that yet another erosion of the property rights of investors is not going to make much difference. On a more positive note, the statutory right to re-pledge is limited to cases where a hard pledge has been made from the Pledgor to the Secured Party and the SEC regulatory restrictions regarding re-pledge apply (at least to Secured Parties subject to those regulations). The fact that conceptual concerns about property seem to have been discarded does not mean that the field has therefore been left entirely open for Secured Parties.

Nonetheless, the fact remains that the kind of property rights awarded to holders in the IHS is very different from the traditional concept of property. For the sake of clarity and coherence in the law, it might be preferable to avoid the term property altogether when describing the rights of entitlement holders under part 5 of Article 8.[192] The informational burden which the property label is designed to alleviate is also a reason

[191] Plank, *supra* note 112 at 1240 and Harris & Mooney: A Property-Based Theory, *supra* note 106 at 2049. Compare also with the discussion in section 3.1 above. The prevailing view of property as a bundle of sticks that can be disassembled at will is also conducive of weaker property rights.

[192] Merrill & Smith, *supra* note 102 at 381 ff and Penner, *supra* note 109 at 819

against using that label where it does not belong. If property is able to assume too many different shapes it will become costly for the world to ascertain what their duties are in relation to a certain thing. This is inefficient and erodes one of the basic efficiency benefits underlying the concept of property.

Although Professor Rogers labels revised UCC as more honest - plainly telling the parties about their rights - honesty should perhaps have been taken even further by describing the investor's right as a 'qualified personal claim' or some other term that that would not imply the usual incidents of traditional property rights.

3.4.2 Legal Realism

Re-pledge is very common in securities markets today and customers of securities intermediaries and participants in OTC derivatives transactions generally consent to re-pledge as a practical matter. This provides a strong argument in favor of revised Section 9-207. In the absence of countervailing policy considerations, legal default rules should reflect the bargain that the parties would generally arrive at on their own so as to avoid the costs of contracting for the contrary. Such countervailing policy considerations do not seem to be present.

First, the very fact that parties are allowed to authorize re-pledge and otherwise dilute their property rights by agreement indicates that positive consent is not regarded as indispensable. Second, while continuing to require consent to re-pledge would protect investors, the drafters have chosen to provide for such protection elsewhere. Of course, one should not rely on the fact that there are other protective mechanisms to justify re-pledge unless one is convinced that these mechanisms are satisfactory. Assuming this is the case, the drafters' choice to repeal Prior Section 9-207 is justified.

In this specific context, there is an another view that deserves consideration. The laws regulating re-pledge outside of Article 9, such as Section 8-504 and the SEC regulations, require that Secured Parties subject to those rules obtain their Pledgors' consentm and Professor Kettering has observed that the right accorded to Secured Parties by Section 9-207(c)(3) is limited as to its practical scope.[193] The fact that the revisions to Article 9 are thus inconsistent with other sources of regulations of re-pledge could be seen as a reason for retaining the consent requirement in Article 9. The argument that legal rules that are not applied should be abolished is, however valid, diminished by the fact that in this particular case, rules with the same effect have elsewhere been left untouched. It should be noted, however, that the scope of the rules differ. Section 8-504 and the SEC regulations, on the one hand, apply to securities intermediaries and should as such reflect policy choices about the specific relationship between intermediaries and their customers. Section 9-207, on the other hand, applies to all Secured Parties and is therefore more concerned with market efficiency than anything else.

3.4.3 Economic Efficiency and Secured Lending

Secured lending has been thoroughly debated in terms of its social merits.[194] Article 9 of the UCC takes a firm standpoint in favor of secured credit; it was drafted to facilitate the extension of secured credit on the assumption that secured lending is beneficial for unsecured as well as secured creditors.[195]

A statutory right to re-pledge is completely in line with the strongly sympathetic policy towards secured lending reflected in Article 9. The belief is that societal benefits

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[193] Kettering, *supra* note 11 at 185 f.

[194] See section 2.5 above.

will arise from the widespread use of secured credit. Re-pledge is just one more way of implementing this policy. It is, apparently, assumed that the markets will work more efficiently and securities will be put to better use if the ability of Secured Parties to engage in secured lending is increased. Accepting these assumptions, the drafters' decision to provide a statutory right to re-pledge is consistent with policy.

Even the strongest advocates of secured credit, however, concede that there should be limits to its availability and that at times other considerations should prevail. One such case would be where there is little evidence to support the usefulness of secured lending in a particular context. However, re-pledge of investment securities is widespread and many commentators have defended its usefulness.[196] Not only are Secured Parties and Re-pledgees said to gain, but securities investors too, since re-pledge enables them to obtain cheap margin financing from their intermediaries.[197]

Considering the general policy underlying Article 9 there thus seems to be no ground for asserting that the drafters were out of line in granting Secured Parties a statutory right to re-pledge. Much can be said in favor of the view that secured financing enhances efficiency and it seems quite clear that there would be great transitional costs if the legal rules were changed so that re-pledge was prohibited altogether. This is, of course, too drastic a comparison, since the state of affairs before the latest revision was that re-pledge could be effectuated with consent. However, the reasons for preserving laws that are generally opted out of are not strong and they are certainly not convincing in

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[195] Harris, S.L. & Mooney, Jr., C.W., "Symposium: How Successful was the Revision of UCC Article 9?: Reflections of the Reporters" 74 Chi.-Kent. L. Rev. 1357 (1999) at 1359

[196] See section 1.2.2 above and references referred to therein.

[197] Schroeder: Radical Reform, *supra* note 8 at 497

this case. Allowing re-pledge is therefore sound policy from the perspective of enhanced efficiency.

3.4.4 Re-pledge and Systemic Risk

The concern that an institutional market participant will fail and that such a failure will create a domino effect leading to the failure of others and, ultimately, systemic break-down provided a great impetus for the 1994 revision of Article 8.

Systemic risk considerations do not support favoring the interests of individual investors. It would require a very large number of customer failures before the market would be systemically endangered. Systemic risk considerations inherently favor large institutions over investors. This is reflected in the rules in Part 5 of Article 8 concerning the IHS.

An unlimited right to re-pledge for secured parties is also justifiable by reference to the need to alleviate systemic risk. The practice of re-pledge is assumed to provide secured parties with more and cheaper financing which, in turn, enhances their liquidity and promotes their ability to fulfill their obligations. The increased risks suffered by investors due to re-pledge are apparently regarded as insignificant when compared to the concerns regarding the viability of the large, institutional market players.

3.4.5 Investor Protection

A. Regulatory Protection or Property Rights

The IHS and the concept of re-pledge are both hazardous for customers of securities intermediaries since they create an environment in which the customers' property can easily be misappropriated and in which their competitors (i.e. transferees) will often be the winners of ensuing priority disputes. Facciolo and, to a lesser extent, Professor Schroeder have professed concerns.

One of the disputes about the protections needed and/or provided for customers in the IHS relates to the fundamental issue of whether such protection should be awarded through commercial law rules or if regulatory protection would be more appropriate, and, also, whether the two schemes are even related to one another. In defending the substantive rules of Article 8, Part 5 from an investor point of view, Professor Rogers concludes that these rules would not have been different in absence of protective regulatory provisions.[198]

Other commentators generally do not share Professor Roger's view, not even those who find the overall scheme sufficiently protective. When Professor Mooney proposed his upper-tier priority system (which preceded Part 5 of Article 8), he acknowledged that protection in the form of compulsory insurance and regulatory efforts would be necessary to protect the interests of individual investors.[199] Similarly, Professor Schroeder has expressed the view that the current regime under Article 8 cannot be upheld unless the regulatory efforts of the SEC and the insurance protection are kept in place to protect consumers from the rules in Article 8, which, she finds, express a clear preference to lenders.[200] The Comments also rely on these additional protections when discussing the risks of holding through intermediaries and state that the "... important policy of protecting investors against the risk of wrongful conduct by their intermediaries is sufficiently treated by other law."[201]. It should also not be forgotten that re-pledge at

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[198] Rogers: Policy Perspectives, *supra* note 57 at 1539
[199] Mooney: Beyond Negotiability, *supra* note 10 at 380 f.
[200] Schroeder: Radical Reform, *supra* note 8 at 300 f.
[201] Official Comment 2 to § 8-511

times involves a Secured Party who is not a securities intermediary and therefore not subject to regulatory control. This of course places the commercial law rules under even stricter scrutiny. Facciolo shares the view that additional protection is needed and he claims the protections currently available are insufficient.[202] He also argues that the proponents of Part 5 of Article 8 rely on unfounded assumptions about the adequacy of the additional protections.[203]

It is sufficient for current purposes to conclude that most scholars seem to agree that investor interests must be protected by legal mechanisms outside of the commercial law rules and, even more importantly, that the content of the current UCC commercial rules contributes to the need for additional protection. It goes beyond the scope of this paper to examine the content and sufficiency of the SEC rules etc. It is more relevant to look at the risks faced by customers and how the rules in the UCC contribute to those risks.

Individual investors will almost invariably be affected by a re-pledge in their role as Pledgors and, as we have seen, are likely to lose a priority dispute with a Re-pledgee. This vulnerability to loss is not specific to re-pledge, but is present throughout the IHS. It is therefore relevant to look at the justifications for Article 8, Part 5 as regards customer protection. If the protective rules are generally sufficient, re-pledge will arguably pose no substantial additional risk for Pledgors.

One justification for the current scheme put forward by Professor Rogers is that stronger protection for owners is not likely to work to the advantage of investors/customers in general since a wrongdoing intermediary is likely to have

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[202] Facciolo, *supra* note 28 at 675 ff.
[203] *Ibid.* at 678 f.

transferred the securities to another intermediary who has acquired those securities on account of its customers.[204] If the customers of the first intermediary are allowed to claim 'their' securities from the second intermediary, the latter's customers will sustain a loss. The overall group of customers is therefore equally disadvantaged regardless of the chosen approach.

Facciolo puts forward two arguments against Professor Roger's thesis.[205] The first is actually an application of the investor protection rules of Article 8. Intermediaries are obligated by Section 8-504 to immediately acquire and maintain securities corresponding to all entitlements they hold for customers. A buying customer is therefore protected as long as his or her intermediary is solvent. The customer has the right to require that the intermediary acquire the assets in question and that right is not affected by the fact that the intermediary's seller has failed to deliver. Facciolo's second argument is that most individual investors are infrequent traders and only rarely assume the role of purchaser. Buyer-friendly priority rules are therefore likely to benefit active (institutional) investors instead of customers.

Facciolo's first counter-argument is particularly convincing. The Article 8 rules rest on the assumption that investors are well protected as long as their intermediaries are solvent. It is difficult to see how this reliance on intermediary integrity is less relevant when the customer is a buyer rather than an owner. It therefore appears that Professor Rogers is trying to put forward individual investor protection policy to justify rules that were originally implemented to protect powerful institutional investors.

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[204] Rogers: Policy Perspectives, *supra* note 57 at 1522 f.
[205] See Facciolo, *supra* note 28 at 642 f.

Advocates of the customer-friendly nature of the rules in Article 8, Part 5 also argue that it is possible for customers to opt-out of the IHS and that those who do not avail themselves of that opportunity must be deemed to have accepted the inherent risks in holding through an intermediary.[206] Facciolo is critical of relying on opting-out as a means of customer protection since the practical ability to do so is limited.[207] He points out that a customer who wishes to be active in the market will find it difficult to perform transfers within the settlement timeframes imposed by the SEC and that many brokers actively discourage customers from holding paper certificates.

Facciolo makes a strong argument on this point. The securities market in general, and the IHS in particular, are conceived of as formidable engines for the economy that provide every participant with great economic advantages. Most commentaries also hold the view that the IHS is the one and only way of structuring that market. The individual investor is a vital ingredient in the market and decreased market participation would presumably have strong negative repercussions. Stating that customers only have themselves to blame for losses they might incur due to intermediary failure is therefore very harsh. The general public is encouraged by public as well as private forces to participate in the market. It is in that context only just that the legislators look after the public's interests. Concerns have been expressed that broker insolvencies may become more common as the markets continue to develop rapidly and as market actors become

[206] See Schroeder: Radical Reform, *supra* note 8 at 354 f.; Guynn, *supra* note 53 at 35 and Mooney: Beyond Negotiability, *supra* note 10 at 402 f. Money advocates the view that one who puts his goods in play assumes the risk thereof and should therefore bear any losses. However, he also observes in note 293 that market participants necessarily *must* employ intermediaries.

[207] Facciolo, *supra* note 28 at 672 ff. In this respect note also Guynn, *supra* note 53 at 35, who concedes that opting-out most likely is connected with efficiency losses.

increasingly creative in inventing new investment vehicles.[208] Protection may therefore be even more necessary and justifiable in the future.

B. Set-off

A right to set-off is useful for a Pledgor where his or her collateral has been re-pledged and the Secured Party is unable to fulfill its obligation to return the collateral. The Pledgor can reduce his or her loss by setting off the obligation owed to the Secured Party against the Secured Party's redemption obligation.[209] Whether a Pledgor has such a right to set-off is not governed by the UCC, but by applicable state law and insolvency legislation.[210]

Allowing the Pledgor to set-off seems intuitively sensible.[211] It appears unjust and illogical to force the Pledgor to pay its debt to the Secured Party even though the Secured Party has an obligation towards the Pledgor. The unfairness of that scenario is what has given rise to the set-off remedy in the first place.[212] Nevertheless, in the event of the Secured Party's insolvency, relevant state law may limit the right to set-off if it imposes strict requirements concerning the mutuality of the debts.[213]

Bankruptcy law may also prove to be problematic for the Pledgor, at least when the Secured Party is subject to the 'regular' rules of the federal bankruptcy legislation.[214] The procedural automatic stay that is imposed at the commencement of 'regular' bankruptcy proceedings precludes exercise of any set-off rights, unless warranted by

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[208] Schroeder: Repo Madness, *supra* note 169 at 1041 f.
[209] Johnson: Derivatives, *supra* note 29 at 951
[210] Kettering, *supra* note 11 at 221
[211] *Ibid.*
[212] Johnson: Derivatives, *supra* note 29 at 981
[213] Kettering, *supra* note 11 at 221
[214] *Ibid.* at 222 f. Special rules apply in the case of broker bankruptcies, which enable the parties to net and set-off their obligations towards each other.

court order.[215] The bankruptcy legislation provides an exemption from the automatic stay when the obligations are part of a 'swap agreement', which includes most derivatives transactions.[216] A Pledgor under an OTC-derivatives transaction should thus be able to find relief in set-off. However, the exemption from the automatic stay on its face only applies to situations where it is the *Secured Party* that is looking to set-off its obligation. A Pledgor would therefore have to hope that the courts would be willing to extend the set-off rights to the converse situation, which seems reasonable.

In any case, a right of set-off provides relief only to the extent of the Pledgor's outstanding obligation.[217] If the collateral has greater value, the value in excess will become an unsecured claim that most likely will remain unpaid. Set-off is thus a protection that may not only be of limited availability but also of limited economic value. As such it cannot be used to dispense with the need for investor protection in the UCC or in regulatory provisions.

3.4.6 Deposit Accounts and Securities Account – Why Property Rights in One but Not the Other?

It may be instructive to conclude this section by comparing the property rights of entitlement holders and those of bank customers to their deposit accounts. A number of commentators have observed the similarities between having money in a bank account and holding securities through a securities intermediary.[218]

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[215] Johnson: Derivatives, *supra* note 29 at 984
[216] *Ibid.*
[217] *Ibid.* at 992
[218] See Kettering, *supra* note 11 at 128; Schroeder: Article 8 at 372 and Mooney: Beyond Negotiability, *supra* note 10 at 403 ff.

someone's hand or deposited in an account, is never anything more than an "abstract unit of account"[222] and it is thus inherently 'thingless'. It is therefore not a suitable object of traditional property rights. Consequently, disputes between depositors or between depositors and other bank creditors are not solved by property tracing rules (even though tracing principles sometimes are applied).[223]

Securities, on the other hand, are not inherently fungible. There are differences between shares in one company and shares in another. They are also not intended to be constantly transferred, even though transferability is a very important aspect of their value. They are therefore not anonymous. Rather, each security, i.e. a certificate, can readily be identified and distinguished from other securities, and it is also relevant to make such a distinction.[224]

Importantly for current purposes, securities lose their identity and personality when the item at issue is a holding with an intermediary and not the actual security. The same kind of securities held with the same intermediary then become fungible and the holder is unable to point to any specific asset that is earmarked for him or her. It was argued in section 3.1.3 that property rights can be accorded only to distinct, identifiable assets and this feature of the securities account strongly suggests that no property rights should be awarded. Professor Mooney also holds that securities accounts should be treated as personal obligations and he, as does Professor Kettering, suggests that the

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[222] Rogers, J.S., "Negotiability, Property and Identity" [hereinafter Rogers: Negotiability] (1990) 12 Cardozo Law Review 471 at 504

[223] Mooney: Beyond Negotiability, *supra* note 10 at 403

[224] Compare in this respect Rogers: Negotiability, *supra* note 222 at 504 where he argues that it is essentially useless to ever ask whether money in one person's hand is 'the same' money that previously was held by someone else.

Bank deposits by natural persons are insured up to $ 100,000,[227] and the same limitation applies for cash holdings with a securities intermediary, whereas claims for securities are insured up to $ 500,000.[228] Interestingly, the threshold for securities claims is much higher than the corresponding amount for cash deposits with a bank, even though investors are thought to have some sort of property right. The interesting question is whether securities investors are better off receiving strong property rights or adequate regulatory protection. Protection via property rights would involve disputes with competing third parties. It could therefore be argued that such protection would be hollow, considering the uncertain outcomes and the time and costs that would be needed for litigation. We have also seen that the priority rules are unfavorable to investors in most cases. Moreover, intermediary shortcomings have been rare to date. Most importantly, the legislator seems to be turning most of its attention to the improvement of the regulatory scheme for intermediaries. Even though this attention is the result of concerns with the overall efficiency of the market and with providing an advantageous environment for intermediaries and other large market participants, it is likely that there will be a beneficial overspill for individual investors as well. It may therefore be in the interests of investors that the treatment of their holdings moves even closer to that of deposit accounts.

3.5 Conclusion

The foregoing has shown that property rights for investors in the IHS differ from traditional property concepts and that investors have to rely largely on the integrity of

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securities intermediaries are found in 15 U.S.C.S., § 78 (2002) as regards compulsory insurance for customers' claims and 15 C.F.R., § 240.15c3-1 (2002) as regards net capital requirements.

[227] 12 C.F.R. § 330.6(a) (2002)

efficiency. The additional risks for Pledgors seem to be limited in practice and the intermediary can cause losses to its customers with or without a right to re-pledge. As we have seen, the transferee will almost always win a priority dispute, a fact that has seemingly not changed in any significant way.

Realistically, the same seems to be true for transactions in which the Secured Party is not a securities intermediary. The participants in OTC derivatives transactions and the like currently accept the risks associated with re-pledge by consenting thereto and are therefore likely to have developed the necessary tools for protecting themselves. The cases where the statutory right to re-pledge is least warranted is where the Secured Party is an unregulated entity and the Pledgor is unlikely to have considered the possibility of re-pledge when entering into the original pledge. Presumably these cases are too rare to make the revision unwarranted and the costs of implementing exceptions from the baseline rule would probably also exceed any potential gains.

There is no need to once again revise Article 9 to reinstate the prior consent requirement for re-pledge. However, the property rights under the IHS are so weak that the 'property rights language' in Article 8 should be discarded. Moreover, there is much to be said for the view that a pledge contemplating re-pledge should be re-characterized as a sale.

The fictions of tracing/following and physical holding of securities are successively being discarded. The time may have come to also dispense with fictional property rights. The detailed implementation of such a reform is beyond this paper. For present purposes, it can only be concluded here that an overt rejection of the prevailing presumption that investors 'own' their securities would likely encounter fierce resistance.

The negative psychological impact on investor confidence may be the main reason why such a reform is unlikely ever to be undertaken.

4. CHOICE OF LAW

When a secured transaction involves a Pledgor, Secured Party or collateral situated in different jurisdictions, it becomes necessary to determine which jurisdiction's law will govern the transaction, not just as regards contractual issues between the parties but most importantly the effects on third parties. Consistently with the focus of this paper, the discussion will concentrate on choice of law in situations where the collateral is securities held through the IHS.[231]

In the USA, choice of law issues also come into play when different states within the US are involved. However, this paper mainly concentrates on the international choice of law context. Revised Article 9 has entered into force in all US states, the District of Columbia and in the US Virgin Islands.[232] The importance of choice of law is obviously lessened by the national adoption of a uniform law since choice of law issues are relevant in practice only when the substantive regimes of the various jurisdictions involved differ on the issue at stake.

[231] The IHS has been described above in section 1.1 as regards the US market. In this section 4 the term will be used to denote the US system as well as similar in place in other markets. For a recount of the IHS internationally, please see Bernasconi, C., Potok, R. & Morton, G., "General Introduction: Legal Nature of Interests in Indirectly Held Securities and Resulting Conflict of Laws Analysis" [hereinafter Bernasconi, Potok & Morton: Introduction], in Potok, R. (ed.), *Cross Border Collateral: Legal Risk and the Conflict of Laws*, (London: Butterworths, 2002), pp. 7-47 (Chapter 2) at 13-19.

[232] Weise, S.O., "An Introduction to Revised UCC Article 9" Heller Ehrman White & McAuliffe LLP, July 1, 2002 at 4. Available on the internet at http://www.hewm.com/news/articles/ucc.pdf (visited July 24, 2002).

4.1 Introduction of Cross-Border Issues

Faced with a choice of law problem, a court must answer two basic questions.[233] The first is what choice of law rules should apply to the transaction or issue; the second is how the choice of law rules apply to the facts of the particular case.[234] As to the first question, it follows from the principle of sovereignty that the court typically uses the choice of law rules of the jurisdiction in which it sits – the forum state.[235] Ideally, the result of a dispute should be the same regardless of where it is adjudicated.[236] However, as long as the choice of law rules differ in different jurisdictions, this goal will not be attained.

An important task for private international law is therefore to strive towards uniformity in domestic choice of law rules, which is most effectively accomplished through the national adoption of international conventions. The recent work of the Hague Conference and the EU are important examples in the securities field. A more general example is the United Nations Convention on the Assignment of Receivables in International Trade (the 'Receivables Convention') which was adopted and opened for signature or accession by the General Assembly in January 2002.[237] These international efforts will be discussed below.

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[233] Whether or not the jurisdiction of the forum court is the proper venue for the dispute in question is a separate issue, which will not be discussed further in this paper. For more on this issue please see Bjerre, C.S., "International Project Finance Transactions: Selected Issues under Revised Article 9" [hereinafter Bjerre: International] (1999) 73 Am. Bankr. L.J. 261 at 267 ff.

[234] Bull, R.E., "Operation of the New Article 9 Choice of Law Regime in an International Context" [hereinafter Bull: Choice of Law] (2000) 78 Tex. L. Rev. 679 at 683 f.

[235] *Ibid.* at 684

[236] Walsh, C., "Transnational Secured Financing Law: Receivables Financing and the Conflict of Laws: The UNCITRAL Draft Convention on the Assignment of Receivables in International Trade" [hereinafter Walsh: Receivables] (2001) 106 Dick. L. Rev. 159 at 163

[237] United Nations, General Assembly Resolution A/RES/56/81 – United Nations Convention on the Assignment of Receivables in Internatinoal Trade, Doc. A/RES/56/81, which contains the official draft of

4.1.1 Substantive Law Issues to be determined

There are three distinct substantive sub-issues that must be resolved in the course of a choice of law analysis in the context of secured transactions.[238] First, it must be decided whether the transaction in fact constitutes a secured transaction as opposed to a true sale or a lease etc. Second, if the transaction is characterized as a secured transaction, it must be decided whether the security interest has been validly perfected, that is, whether all requirements for making the interest effective against third parties have been satisfied under the applicable national law. Lastly, the applicable law will determine the secured party's priority or rank against competing claimants.

4.1.2 General Principles of Choice of Law

Ideally, choice of law rules should be designed to ensure clarity and predictability as to which jurisdiction's substantive law will govern an international transaction.[239] This is of obvious first importance for the parties who are planning a secured transaction,[240] as they need to know what measures they must take to ensure the efficiency of their transaction. Moreover, if it is impossible to determine the governing law with sufficient certainty, the parties will invariably elect to comply with the substantive laws of every jurisdiction to which the transaction is connected, thereby inflicting transaction costs to an extent that may make the transaction financially unfeasible.[241] To avoid this, choice of law rules should be based on simple objective facts that can be established without

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the Receivables Convention. The document is available on the internet at www.uncitral.org, under the heading News and Meetings (visited on August 15, 2002).

[238] Bull: Choice of Law, *supra* note 234 at 688. Please note that the separation of the issues regarding perfection and priority displays a distinctively US perspective. For more on this, please see section 4.4 below.

[239] Bjerre: International, *supra* note 233 at 270 and Walsh: Receivables, *supra* note 236 at 163

[240] Bjerre: International, *supra* note 233 at 269 f.

extensive and expensive investigations.[242] Clear and predictable choice of law rules are important in the context of litigation as well. Courts will be able to reach uniform and consistent decisions if the rules are easily accessible and uncomplicated to apply and precedents will be more reliable, for courts and parties alike.

For those reasons, the immediate contracting parties are generally allowed to agree between themselves on the applicable governing law;[243] the parties' agreement arguably being the most practical of all connecting factors and one that runs very little risk of producing results that are contrary to the parties' expectations. Another established principle is that the choice of law rules shall designate the laws of the jurisdiction in which enforcement of an order can be obtained.[244]

However, since party autonomy is restricted for issues for which there is a potential for third party conflicts,[245] issues relating to transfer or creation of property rights in moveables are traditionally governed by a mandatory choice of law rule: the *lex situs*, i.e. the law of the jurisdiction where the relevant asset is situated.[246] The lex situs rule has prevailed largely because the location of property is generally an objective fact which means that the governing law can be readily ascertained by the parties at the transactional stage, as well as by third parties.[247] If the debtor and secured party were instead free to select the applicable law, this would make it possible for them to choose the law of the jurisdictions with the most favorable priority rules.[248] There are no

[241] Walsh: Receivables, *supra* note 236 at 163
[242] Kuhn, H., "Multi-State and International Secured Transactions under Revised Article 9 of the Uniform Commercial Code" [hereinafter Kuhn: Multi-State] (2000) 40 Va. J. Int'l L. 1009 at 1036
[243] Walsh: Receivables, *supra* note 236 at 186
[244] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 29
[245] See section 4.1.4 below
[246] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 8
[247] Walsh: Receivables, *supra* note 236 at 172
[248] *Ibid.* at 171

convincing policy reasons for why the parties should be thus permitted to escape an unwanted domestic perfection or priority regime.

The traditional *lex situs* rule is not directly workable for transactions involving intangibles, since an intangible has no physical location. The emerging trend seems to be to develop different choice of law rules for different categories of intangibles. For example, the Receivables Convention, which deals with the assignment of receivables, by way both of sale and security, adopts the location of the assignor as the relevant connecting factor for deciding the perfection and priority of the assignee's right in the receivable.[249] The location of the assignor was thought to respond most efficiently to the needs of the receivables financing market.[250] In modern receivables financing, an assignment often encompasses a bulk of receivables owed by debtors located in different jurisdictions, it would be commercially onerous if the assignee were required to conform to the perfection and priority rules of all laws governing the debts (i.e. the laws of all debtors).[251] Thus, we again see how the demands of the market place are becoming the predominant influence in modern law making.

The Receivables Convention excludes receivables generated from investment securities from its scope.[252] It was apparently assumed that the choice of law rules in the Receivables Convention were inappropriate for this category of property. Was that assumption correct for indirectly held securities? If the Receivables Convention applied, the receivables generated by the securities would be governed by the Pledgor's law, while

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[249] Receivables Convention Article 22

[250] Walsh: Receivables, *supra* note 236 at 174

[251] *Ibid.* at 173 f., who explains at 171 ff. that there are conceptual reasons underlying this choice as well. The law governing the contract between the parties is usually chosen by them, which makes the law of the contract inappropriate for priority issues, which have obvious third party implications. Alternatively, the law of the debt or the law of the receivable could have been chosen. However, these are practically impossible in the modern market.

the Secured Party's jurisdiction would govern the law applicable to the same securities in the event of a re-pledge. The possibility of having two different laws governing the same receivables seems a possible reason why the Receivables Convention should not apply to the transfers of receivables generated by indirectly held securities. However, this same potential also exists under the UCC and the Hague Convention, as is explained below, and may even be the preferred result.[253]

4.1.3 Renvoi

'Renvoi' denotes a choice of law rule which refers to the whole of the relevant jurisdiction's law, including its choice of law rules.[254] In theory, the purpose of renvoi is to ensure uniformity of result no matter where the dispute is adjudicated.[255] Within the US, differing results are unlikely to be a problem since Article 9 is substantively uniform among all states.[256] Internationally, there is more potential for substantive divergence, even though most jurisdictions share the same general policies in secured transactions

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[252] Receivables Convention Article 4.2

[253] See sections 4.2.5 and 4.3.5 below and in particular 4.2.5 B. See also United Nations Commission on International Trade Law, Thirty-fourth session, Vienna 15 June – 13 July 2001, Receivables Financing – An Analytical Commentary on the Draft Convention on Assignment of Receivables in International Trade, Doc. A/CN.9/489 at paras 47-54. The stated reason for this exclusion is that the Receivables Convention would not be well suited to regulate choice of law issues relating to such assets. This is due to the fact that transactions dealing with investment securities generally are such that either party could be debtor or creditor at different points in time and the transactions are generally subject to netting arrangements. If one of the obligations under such a bilateral contract could be extracted by way of assignment, the credit risk situation of the transaction would change which could result in the unraveling of the whole transaction or an increase in transaction costs. Such a situation is regarded as a potential contributor to systemic risk.

[254] McDougal, III, L.L., Felix, R.L. & Whitten, R.W., *American Conflicts Law*, 5th ed. (New York: Transnational Publishers Inc., 2001) at § 7 p. 12

[255] *Ibid.* at § 7 p. 13

[256] Kuhn: Multi-State, *supra* note 242 at 1038. The differences between the US and the rest of the world will decrease if the Hague Conference adopts the proposed Convention and it becomes widely implemented. For more on this, please see section 4.3 below.

law, i.e. clarity and predictability for creditors looking to perfect security interests or investigate prior encumbrances.[257]

However, there are strong arguments for rejecting renvoi, especially in the commercial law context. Most importantly, renvoi undermines the need for simple and clear rules for the parties when they are planning their transaction.[258] Since it becomes more complicated and difficult for the parties to predict the outcome if renvoi is involved, the doctrine is considered inconsistent with contemporary choice of law-thinking.[259]

Renvoi is also suspect from the point of view of domestic choice of law policy. The choice of law rules of any given jurisdiction have presumably been developed with a particular policy goal in mind. For instance, a state may have decided that issues relating to property disputes are best governed by the laws of the jurisdiction where the property is located on the theory that this best corresponds to the reasonable expectations of the parties and third parties as well as the public at large. If renvoi is applied and the jurisdiction where the property is located has a different choice of law rule, the forum state would effectively have abandoned its policy choice in favor of the other state's choice.[260]

For these reasons, the Receivables Convention, the UCC and the Hague Convention have all rejected application of the doctrine of renvoi.[261]

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[257] Bjerre: International, *supra* note 233 at 270
[258] *Ibid.* at 269 f.
[259] Kuhn: Multi-State, *supra* note 242 at 1036
[260] Kramer, L., "Return of the Renvoi" (1991) 66 N.Y.U.L. Rev. 979 at 989 f.
[261] See UCC Section 9-301 and Official Comment 3 to § 9-301 and the Hague Convention Article 9.

4.1.4 Party Autonomy

The parties to a transaction normally are not permitted to agree on the applicable law to govern the property aspects because third party rights are potentially; this policy accords with the substantive contract policy of most jurisdictions.[262] To allow unqualified party autonomy in choice of law would "...undermine(s) the integrity of all national property law standards aimed at the protection of third parties and enacted in the interest of national public policy."[263]. If the law most closely connected with the particular transaction imposes mandatory limitations on the rights of the parties for the protection of competing claimants etc., it would undermine that protective policy to allow the parties to evade the mandatory rules simply by choosing a different governing law. If the parties are unable to exclude a mandatory domestic rule by contract, it follows that they should equally be unable to evade it by a choice of law clause.

There are other efficiency reasons why party autonomy is inappropriate on issues involving third party rights. Third parties would need to consult the parties' agreement in order to determine what law governed perfection and priority. As a practical matter, the agreement may be difficult to obtain and the resulting transactions costs would be onerous.

4.2 Choice of law under the UCC

4.2.1 Party Autonomy

The UCC contains a general rule that allows the parties to choose the law applicable to their transaction. Section 1-105 states that the parties may agree that the law

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[262] Walsh: Receivables, *supra* note 236 at 161

of any state or nation may govern their rights and duties as long as the transaction bears a *reasonable relation* to the chosen jurisdiction. However, party autonomy is limited in certain areas. Section 1-105(2) provides that where another article in the UCC expressly designates the applicable law, agreements to the contrary are effective only to the extent permitted by that article.

The US requirement for a reasonable relation between the chosen jurisdiction and the transaction at issue is generally not found in other choice of law regimes. The Rome Convention[264] contains no equivalent restriction,[265] and neither does the Civil Code of Quebec[266]. The US approach reflects a certain level of distrust in international unification efforts and in the legal systems of foreign jurisdictions. It is also somewhat maternalistic, in that it seeks to protect US citizens and entities from having to transact or litigate under foreign law. It is doubtful that this kind of protection is generally needed given the global US business presence.

More importantly, the requirement for a reasonable relation to the chosen law undermines the policy underlying the principle of party autonomy for contractual issues, because it diminishes clarity and predictability for parties to international transactions. Historically, US courts have tended to invalidate choice of law clauses for lack of reasonable relation in order to further fundamental US domestic intersts.[267] The concern seems unwarranted when the substantive law issue is merely contractual, since the parties

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[263] *Ibid.* at 172

[264] EC, *1980 Rome Convention on the Law Applicable to Contractual Obligations*, O.J. C 27, 26/01/1998 p. 34 – 46, available on the internet at: http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=41998Y0126(03)&model=guichett (visited on August 15, 2002).

[265] Rome Convention Article 3

[266] See Article 3111 of the Quebec Civil Code

[267] Richman, W.M. & Reynolds, W.L., *Understanding Conflict of Laws*, 2nd ed. (New York: Matthew Bender & Co., Inc., 1993) at § 72

would have been free to resolve the issue by agreement, the refusal to allow them to choose a foreign law seems to have no justification other than to ensure the application of US law, but at the expense of certainty and predictability.

4.2.2 Choice of Law in Secured Transactions Regarding Investment Property: Section 9-305

A specialized choice of law rule for secured transactions is found in Section 9-301. Under subsection 1, except as otherwise provided, the law governing perfection, the effect of non-perfection and priority is the law where the debtor is located. Section 9-301 explicitly states that this rule is subject to the more specialized rules for investment property found in Section 9-305.

The choice of law rules for secured transactions involving securities accounts and securities entitlements are stated in Section 9-305(a)(3). The baseline rule is that the law of the securities intermediary's jurisdiction governs the issues of perfection, the effect of perfection or nonperfection, as well as priority.

The Comments indicate that the reason for this approach is to ensure consistency with the choice of law approach in Article 8.[268] Choice of law issues relating to the relation between a customer and its securities intermediary are addressed by Section 8-110(b), which also points to the law of the intermediary's jurisdiction. The alleged policy is to provide the customer and the intermediary with a "...single, readily-identifiable body of law to determine their rights and duties."[269].

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[268] Official Comment 2 to § 9-305
[269] Official Comment 3 to § 8-110

There are exceptions to the baseline rule in Section 9-305(a)(3). Section 9-305(c) lists three cases where *perfection* is governed by the law of the debtor's location, instead of the law of the intermediary's jurisdiction. Subsection (c)(1) deals with security interests perfected by filing, and subsection (c)(2), of greater interest for current purposes, states that automatic perfection of a security interest created by a broker or securities intermediary is governed by the law of the debtor. A security interest in investment property is automatically perfected when it attaches, if the debtor is a broker or a securities intermediary.[270] This rule thus applies to re-pledges by Secured Parties who are brokers or securities intermediaries.

If the Re-pledgee requires that the re-pledge be a 'hard' pledge, it will obtain control and thus be considered at least if Article 9 is the applicable substantive law. In some circumstances the re-pledge takes the form of an 'agreement to plegde' or an 'agreement to deliver'.[271] Under the substantive rules of Article9, the Re-pledgee's interest is considered as automatically perfected. This rule is designed to facilitate current secured financing practices for securities firms, a requirement for filing a financing statement was, it was argued, unnecessary in revised Article 9 since prior law also made it possible to perfect security interests without filing or taking possession.[272] Since it was thus already possible to create 'secret liens', the securities community was deemed to be aware of and already comfortable with that risk.

The Comments express some concern that the choice of law rules in some instances may direct the forum court to apply a law other than that of a US debtor, i.e. the

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[270] § 9-115(4)(c)

[271] Official Comment 6 to § 9-115 (1998). This section has been repealed in the 1999 revision of Article 9 but its rules have been moved to §§ 9-301 through 9-306 without substantive changes. The statements in the Comments are therefore still relevant.

law of the debtor's securities intermediary.[273] If that jurisdiction is a foreign country that has not adopted a substantive regime equivalent to Article 9, the concern is that the secured party's rights against third parties under the applicable law might be greater than would be the case if the UCC applied.[274]

4.2.3 Securities Intermediary's Jurisdiction: Section 8-110(e)

The location of the securities intermediary for choice of law purposes is determined according to the rules in Section 8-110(e). The primary rule is that the parties are allowed to expressly specify the intermediary's jurisdiction for purposes of the UCC in their agreement.[275] If no such specification has been made, then the parties' designation of a particular jurisdiction to govern their agreement, or the designation of the location of the relevant account is deemed to be the jurisdiction of the intermediary.[276] If the agreement is silent on all these issues, the relevant jurisdiction is the one where the intermediary's office is located; this is identified as the office where carrying the account is carried or, as a last resort, where the intermediary has its chief executive office.[277] There is no requirement under Section 8-110(e) that there be a 'reasonable relation' between the chosen jurisdiction and the transaction or parties.[278] This is defended on the basis of the need for clarity and predictability; by allowing the

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[272] *Ibid.*

[273] Official Comment 9 to § 9-103 (1998). This section has been repealed in the 1999 revision of Article 9 but its rules have been moved to §§ 9-301 through 9-306 without substantive changes. The statements in the Comments are therefore still relevant.

[274] *Ibid.*

[275] § 8-110(e)(1)

[276] § 8-110(e)(2) and (3)

[277] § 8-110(e) (4) and (5)

[278] Official Comment 3 to UCC Appx. I, § 8-110

parties to designate the intermediary's jurisdiction they are able to easily assess, at the outset, what the applicable substantive law will be.[279]

4.2.4 Special Rules for International Secured Transactions

Section 9-307 provides special rules for establishing the location of a foreign debtor. The goal is to prevent foreign law from governing perfection, effects of nonperfection and priority in cases where the debtor is located outside the US, unless that foreign jurisdiction has a system for public notice of security interests that is similar to that of the United States.[280] In such cases, foreign debtors are deemed to be located in the District of Columbia, with the result that the Article 9 filing rules of that District apply.

This exception arguably runs counter to the objectives of clarity and predictability. A foreign debtor's location depends on the content of the substantive perfection rules of his or her home jurisdiction. The collateral taker must therefore investigate the foreign law and assess whether it is sufficiently similar to the US Article 9 filing rules. This may often involve a difficult judgment call. [281] Since creditors are famously risk averse they are likely to investigate the issue extensively and if there is any doubt make precautionary filings in the District of Columbia. The costs thus incurred will be passed on to the borrowers in the end.

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[279] *Ibid.* See section 4.4.1 for a discussion whether this policy choice is valid also when proprietary aspects are concerned.

[280] Kuhn: Multi-State, *supra* note 242 at 1046

[281] Cohen, N.B. & Smith, E.E., "International Secured Transactions and Revised UCC Article 9" [hereinafter Cohen & Smith: International Secured Transactions], (1999) 74 Chi.-Kent L. Rev. 1191 at 1203

4.2.5 Re-pledge Involving Different Jurisdictions

Under the UCC, an original pledge by the Pledgor will be governed by the law of the jurisdiction in which its intermediary is located. When it comes to re-pledge, however, things are a little more complicated.

A. The Secured Party is a securities intermediary

If the Secured Party is a securities intermediary, different choice of law rules apply with regards to the *perfection* of the re-pledge depending on the mode of perfection. If the Re-pledgee's security interest is automatically perfected, Section 9-305(c) states that the law of the debtor's jurisdiction to govern perfection. The perfection of both the original pledge and the re-pledge will then be governed by the laws of the same jurisdiction, i.e. that of the location of the Secured Party.

If the Secured Party (i.e. the debtor) is a foreigner, we have seen that it is deemed to be located in the District of Columbia, unless its home jurisdiction has a system for publicizing security interests that is similar to that of the US, e.g. Canada.[282] US law will then govern perfection issues in relation to the re-pledge. US law would also govern the priority issue if the Re-pledgee (located in the United States) holds its securities with an intermediary in the USA. However, different laws would apply to the re-pledge and the initial pledge since the UCC would refer the initial pledge to the law of the Pledgor's securities intermediary, who in fact is the Secured Party.

The Re-pledgee's interest might instead be perfected by control. The entitlement is then transferred to the Re-pledgee's account with an intermediary and that intermediary's jurisdiction will govern the issue of perfection. If that jurisdiction is

[282] Bjerre: International, *supra* note 233 at 274

different from the Secured Party's, different substantive laws will apply to the question of perfection of the two pledges, since perfection as regards the initial pledge will be governed by the Secured Party's jurisdiction.[283] The same would be true for issues concerning priority, since they are always governed by the law of the securities intermediary's jurisdiction.

B. The Secured Party is not a securities intermediary

Section 9-305(c) would not apply to a re-pledge involving a Secured Party who is not a securities intermediary, regardless of the mode of perfection. The law governing that issue would instead be the law of the jurisdiction of the Re-pledgee's intermediary. The same is true for issues of priority. If that intermediary is foreign and the Secured Party's intermediary is located in the United States, different substantive rules will apply to the pledge and the re-pledge.

It may not be problematic to have priority issues concerning the initial pledge and the re-pledge governed by different substantive laws at least if we assume that the Secured Party's performance of the re-pledge is effected under the laws of the jurisdiction governing its relationship with the Pledgor. If so, it is probable that that jurisdiction recognizes the priority of the Re-pledgee. As we have seen above, this is the case in the UCC, and there would be little point for a Re-pledgee to pursue lending in reliance on re-pledge if the security thus created did not have effective priority.

In fact, the division of the substantive law applicable to the original pledge and the re-pledge is probably welcome, even if not intended. It is essential that the law

[283] The Secured Party's holding of the collateral is deemed to be 'at its own level' in the layers of intermediaries after the initial pledge as well, i.e. by itself for itself. This is the suggested interpretation for the Hague Conference's proposed Convention and it should presumably apply to the UCC as well. See more in section 4.3.5 below.

governing the re-pledge recognizes the Re-pledgee's priority right. One efficient way of reaching such a result is to direct the choice of law towards jurisdictions that allow re-pledge, i.e. the Secured Party's jurisdiction. However, the policy of having one single and readily identifiable choice of law rule obviously has had to yield to the interest of promoting re-pledge and supporting contemporary financing practices. As we have seen, this is not the first time that market demands have been deemed more important than conceptual coherence.

4.3 The Hague Convention

This section will explore the history and objects of the proposed Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary[284] to be adopted by the Hague Conference on Private International Law[285].

4.3.1 The Hague Conference

The Hague Conference is a permanent intergovernmental organization.[286] As of June 18, 2002, the Hague Conference had 61 member states.[287] Many non-members states have acceded to certain of its conventions and the work of the Conference currently involves 112 countries all over the world.[288]

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[284] *Infra* note 296

[285] Hereinafter the 'Hague Conference'

[286] http://www.hcch.net/e/infosheet.html#Background (visited July 18, 2002). For general information about the Hague Conference, please see its website at www.hcch.net.

[287] http://www.hcch.net/e/members/members.html (visited July 18, 2002). The member states include Argentina, Canada, China, France, Germany, Great Britain, South Africa and the USA.

[288] Bernasconi, C. and Potok, R., "The Future Hague Convention on Indirectly Held Securities" [hereinafter Bernasconi & Potok: Hague Convention] in Potok, R. (ed.), *Cross Border Collateral: Legal Risk and the Conflict of Laws*, (London: Butterworths, 2002), pp. 615-623 (Chapter 28), at 617

The purpose of the Hague Conference is to "work for the progressive unification of the rules of private international law."[289]. In order to achieve this goal multilateral treaties and conventions are negotiated and drafted.[290] The preparatory research performed within the organization results in preliminary draft documents that are ultimately discussed and adopted at the plenary sessions.[291] Member states become obligated to apply a certain convention through its ratification.[292]

4.3.2 The History and Objectives of the Hague Convention

A Special Commission[293] set up by the Hague Conference met in The Hague in May 2000 where the immediate practical need for legal certainty regarding choice of law when securities are used as collateral was recognized.[294] The Special Commission concluded that this question should be placed on the Hague Conference's agenda for future work and that the project should be undertaken with priority.[295] A Preliminary draft Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary[296] was adopted by the Special Commission on June 15, 2002. The

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[289] Article 1 of the Statute Of The Hague Conference On Private International Law, available on the internet at: http://www.hcch.net/e/conventions/text01e.html (visited July 18, 2002)

[290] http://www.hcch.net/e/infosheet.html#Operation (visited July 18, 2002)

[291] *Ibid.* [i.e. http://www.hcch.net/e/infosheet.html#Operation]

[292] http://www.hcch.net/e/faq/faq.html#11 (visited July 18, 2002)

[293] The Special Commission on General Affairs and Policy of the Hague Conference on Private International Law.

[294] Report on the Law Applicable to Dispositions of Securities Held through Indirect Holding Systems, [hereinafter the Hague Report]. The Hague Report is available on the internet: http://www.hcch.net/e/workprog/coll_sec_pd1.pdf (visited July 18, 2002).

[295] *Ibid.* at 1

[296] Hereinafter the 'Hague Convention'. The document is available on the internet: ftp://ftp.hcch.net/doc/sec_pd15e.doc (visited July 18, 2002). Hereinafter in this section, references to 'Articles' are to Articles in the Hague Convention as it stands in the June 2002 Preliminary Draft. More information about the Hague Convention is available on the Hague Conference's website under the heading Work in Progress.

current goal is to hold a diplomatic session in October 2002 where the final text of the Convention will be adopted.[297]

One of the main objectives of the Convention is to create clear and predictable rules that will enable market participants to ascertain in advance what law will govern the proprietary aspects of their transactions.[298] The need for unification is pressing since most jurisdictions have substantive as well as choice of law rules that do not reflect the realities of the market.[299] These rules are mostly outdated and it is often difficult to ascertain what they are, which increases the costs that ultimately are passed on to the pledgors.[300] Moreover, the volume and size of the transactions are so great that these uncertainties produce risks of a systemic nature.[301]

4.3.3 Place of the Relevant Intermediary Approach (PRIMA)

The Hague Convention has chosen 'PRIMA', an acronym for 'the Place of the Relevant Intermediary Approach' as the connecting factor for determining the applicable substantive law, the relevant intermediary being the intermediary with whom the holder has a direct relationship.[302] It was initially assumed that the location of the intermediary would be decided by reference to the place where the relevant securities account is maintained,[303] as the place where orders relating to the account could effectively be enforced.

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[297] http://www.hcch.net/e/workprog/sec_flyer.html#rdw (visited July 18, 2002)

[298] The Hague Report, *supra* note 294 at 6

[299] *Ibid.* at 3. See also Bernasconi & Potok: Hague Convention, *supra* note 288 at 615. The anthology in which their article is published contains national reports on the choice of law rules in 24 different countries. According to Bernasconi & Potok these reports "...reveal a rather disparate picture...".

[300] Bernasconi & Potok: Hague Convention, *supra* note 288 at 615 f.

[301] *Ibid.* at 616

[302] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 30

[303] Report on the Meeting of the Working Group of Experts (15 to 19 January 2001) and Related Informal Work Conducted by the Permanent Bureau on the Law Applicable to Dispositions of Securities

PRIMA is said to be a result of the development of modern holding structures for securities. Its application will, among other things, enable collateral takers to look to the laws of a single jurisdiction, even when the collateral is a portfolio containing securities issued in many different jurisdictions.[304]

PRIMA reflects the solution already adopted in the UCC. Belgium, Luxembourg and France have also implemented choice of law rules embodying the PRIMA principle.[305] The EU has followed suit in the Directive on Settlement Finality[306] as well as in the Collateral Directive[307]. The latter was adopted on June 6, 2002 and is intended to also unify the substantive law relating to the use of securities as collateral in transactions involving parties from several member states.[308] Article 9(1) of the Collateral Directive states that issues related to book entry securities shall be governed by the law in the country where the relevant account is maintained (excluding renvoi).

4.3.4 The Rules in the Hague Convention

A. Definitions and scope

Held with an Intermediary [hereinafter Working Group Report], Hague Conference on Private International Law, Prel. Doc. No 13, June 2001, at 17. The Working Group Report is available on the internet at ftp://ftp.hcch.net/doc/scrpte_jan01.doc (visited July 20, 2002).

[304] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 31

[305] *Ibid.* at 43

[306] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems, Official Journal L 166, 11/06/1998 p. 45 – 50 [hereinafter the 'Settlement Finality Directive']. The document is available on the internet at http://europa.eu.int/eur-lex/pri/en/oj/dat/1998/l_166/l_16619980611en00450050.pdf (visited July 20, 2002)

[307] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on Financial Collateral Arrangements, Official Journal L 168, 27/06/2002 p. 43 – 50 [hereinafter the 'Collateral Directive']. The document is available on the internet at: http://europa.eu.int/eur-lex/en/dat/2002/l_168/l_16820020627en00430050.pdf (visited July 25, 2002). See also the Proposal for a Directive of the European Parliament and of the Council on Financial Collateral Arrangements (presented by the Commission), COM/2001/0168 final - COD 2001/0086 [hereinafter the 'Collateral Directive Proposal'], which contains an 'Explanatory Memorandum'. This document is also available on the internet at http://www.europa.eu.int/eur-lex/en/com/pdf/2001/en_501PC0168.pdf (visited July 20, 2002). The Collateral Directive entered into force on June 27, 2002 and the member states have until December 27, 2003 to bring their national legislations into compliance with the directive, see Articles 12 and 11.These legislative acts of the EU will be discussed further in section 5 below.

Article 1 of the Hague Convention defines a 'disposition' as any transfer of title as well as any grant of a security interest. The term 'securities held with an intermediary' is defined as the rights the holder can assert against the intermediary following the credit of securities to a securities account, regardless of whether that right is regarded as a property right or a personal claim.

The scope of the Convention is set out in Article 2(1). The issues covered include the legal nature and the effect of crediting securities to an account and of a disposition from such an account, the perfection requirements for a disposition and issues of priority. It is specifically stated in Article 2(2) that the Convention does not apply to contractual or other personal rights and duties between transacting parties or between a holder and an intermediary.

B. Determination of applicable law

Article 4(1) contains the primary rule for the determination of the applicable law. Two alternative solutions are presented. Both provide that the account holder and the intermediary are allowed to agree on the applicable law.[309] The difference between Options A and B is whether the agreement designates a State "as the State whose law governs those issues" ('those issues' being the ones listed in Article 2(1)) (Option A) or "as the State in which the securities account is maintained" (Option B). However, regardless of whether Option A or B is used, the choice of jurisdiction is only valid if the

[308] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 45

[309] Note in this respect that the choice of law is made by the account holder and the intermediary and *not* by the provider of collateral and the secured party. For more on this, please see Working Group Report, *supra* note 303 at 17 f.

relevant intermediary has an office in the relevant state that handles entries on the books of securities accounts.[310]

There is a default rule in Article 5 which applies if the applicable law cannot be determined by Article 4. The default rule is relevant if the parties fail to assign an applicable law, if their choice cannot be respected because it does not conform to the requirement that accounts are maintained in that State, or if it cannot, under the rules in Article 4, be determined where the account is located. Under Article 5(a) the applicable law is the law in the State or territory of a Multi-Unit State[311] in which the intermediary is incorporated or organized. If this test fails, subsection (b) provides that the intermediary's principal place of business is the determining factor.[312]

PRIMA places great importance on the fact that the intermediary is located where the relevant account is maintained. The default rule therefore only applies when the parties' efforts to assign a location to the account have been unsuccessful and the determination would be too intricate and too costly. The actual location of the intermediary is, in any event, the natural default rule since it is an objective fact that can be readily determined *ex ante*.

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[310] See Article 4(1)(a)-(d)

[311] A 'Multi-Unit State' is defined as a state in which there are territorial units with their own rules in relation to these matters. See Article 1.

[312] Article 5(c) regulates cases in which the relevant intermediary is incorporated or organized under the 'federal' laws of a Multi-Unit State, and not in one of its territories. In that case the relevant jurisdiction is the territorial unit in which the intermediary has its principal place of business. Article 11 is also particular for Multi-Unit States. It states that if the parties have chosen a territorial unit as the place governing the law of their relationship under Option A of Article 4(1) then Article 11(1)(a) specifies that the parties' reference to applicable law shall be to that territorial unit. Have the parties designated a specific territorial unit as the location under Option B, then Article 11(1)(b) provides that it is sufficient that the intermediary has an office in the Multi-Unit State and not necessarily in that territorial unit.

4.3.5 The Hague Convention and Re-pledge

Although the Hague Convention does not address the choice of law to govern the permissibility of re-pledge as such,[313] its rules will apply to re-pledges that are effectuated in member states.

A. The Secured Party is a securities intermediary

If the Secured Party is the Pledgor's securities intermediary, the Secured Party will simply continue to hold the securities after the initial pledge, for itself instead of for the Pledgor. For the purposes of the Hague Convention, the location of the Secured Party, i.e. the intermediary holding the relevant securities, remains the relevant place and that jurisdiction's law will govern the initial pledge.[314] That same law would also govern a re-pledge that does not involve a transfer to the Re-pledgee's intermediary, since the Secured Party is still the intermediary holding the securities, albeit now for the Re-pledgee's account.

Suppose, as an example, that the re-pledge does involve a transfer to an account held for the Re-pledgee with a different intermediary than the Secured Party. The jurisdiction of the Re-pledgee's intermediary would then govern the re-pledge. The result is that different laws would apply to each pledge if the Secured Party and the Re-pledgees intermediary were located in different jurisdictions.

B. The Secured Party is not a securities intermediary

If the Secured Party is not an intermediary, a 'hard' initial pledge would mean that the securities would be transferred to the Secured Party's account with an intermediary. The initial pledge would then be governed by the Secured Party's

[313] Bernasconi & Potok: Hague Convention, *supra* note 288 at 621

intermediary's jurisdiction. The governing law of the re-pledge would be determined in the same manner as described above.[315] Once again different laws would govern the two pledges when the intermediaries are situated in different countries.

In sum, situations may arise where different substantive laws govern the initial pledge and the re-pledge. However, as explained earlier,[316] this may not be too serious a concern, and may even have been intended, if the assumption made earlier about the desire to ensure coherence in the applicable substantive priority rules is correct.

4.4 Comparison between the UCC and the Hague Convention

4.4.1 Party Autonomy

The choice of law rules in the Hague Convention are very similar to those in the UCC. The parties' ability to choose the applicable law is, however, more limited in the Hague Convention than in Section 8-110(e). The former requires that the chosen jurisdiction be one in which the intermediary has an office that handles securities accounts. The general UCC limitation rule in Section 1-105 is inapplicable.[317] Consequently, the UCC allows choices that would be impermissible under the Hague Convention.

One possible explanation for this difference is that the Hague Convention was developed in a more international context than the UCC, and is thus more concerned with ensuring that the applicable law coincides with a jurisdiction where effective enforcement can be had. The main goal of the UCC is to find solutions for multi state transactions

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[314] Bernasconi, Potok & Morton: Introduction, *supra* note 231 at 40 (in note 95)
[315] See section 4.3.5 A.
[316] See section 4.2.5 B.

within the US that facilitate national market needs. Concerns with enforcement issues are not as great, since it is less cumbersome to enforce out-of-state judgments in another US state than it is to enforce foreign judgments in a different nation. Moreover, the universal enactment of the UCC and the consequential uniformity of the substantive rules of all states within the US lessens concerns about having a disconnected law apply in the internal US context.

In an international context, the rules in both the UCC and the Hague Convention may be too supportive of party autonomy and not sufficiently protective of third party interests. The effect of the rules in both the UCC and the Hague Convention is that choice of law in essence is left to the parties' choice. The UCC refers to the law of the intermediary, which the parties are free to agree on.[318] The only exception from this is that *perfection*-issues are governed by the debtor's jurisdiction in cases of automatic perfection.[319] Accordingly, choice of law for priority and other matters with third party effects is delegated to the contracting parties. The same is true for the Hague Convention in which proprietary and priority issues are governed by the parties' choice of law,[320] except for the minor qualification that the intermediary have an office in the chosen jurisdiction.

It was earlier emphasized[321] that parties are usually prohibited from agreeing on choice of law for issues which potentially affect third parties. The reasons for this policy are strong and convincing. Why has this well-established prohibition been abandoned in the securities context? While no definitive answer can be posited, one plausible

[317] Official Comment 3 to § 8-110
[318] See UCC §§ 9-305(a) and 8-110(b) and (e)
[319] See UCC §§ 9-305(c) and 9-115(4)(c)
[320] See Articles 2(1) and 4(1)

explanation is, once again, that the realities of the market have forced a shift in policy. The economies of the world are largely dependent on the workings of the financial market and it is emphasized everywhere today that the efficiency of this market must be supported and furthered. The big players in the market therefore have great bargaining and lobbying power and it can be assumed that they have a lot to gain from being able to determine the applicable national law for themselves. Undoubtedly, their choice would point to law that ensures upper-tier priority is preserved (we have seen an example of this already)[322]. Nonetheless, this strong focus on party autonomy is surprising in a US context, considering the traditional US insistence on a 'reasonable relation' to a chosen jurisdiction.[323]

4.4.2 Bifurcation of perfection and priority

The division found in the UCC between the choice of law for matters of perfection on the one hand and priority on the other is absent in the Hague Convention. One reason for this may be the fact that the clear distinction drawn in the UCC between the mechanics of perfection on the hand and the effects of perfection and priority on the other is not always found in the laws of other countries.[324] Problems may therefore arise in cases where non-US law applies to either of the issues if it is impossible to separate the two concepts under the applicable foreign law.[325]

The reason given for this bifurcated approach is to ensure that the competing claims of creditors not governed by Article 9, such as lien creditors, and Article 9

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[321] See section 4.1.4 above
[322] See section 4.2.5 B. above.
[323] See section 4.2.1 above.
[324] Cohen & Smith: International Secured Transactions, *supra* note 281 at 1242

creditors are governed by the same substantive law as regards perfection,[326] in order to prevent the law of non-Article 9 jurisdictions according certain creditors too strong a priority. Under the UCC, automatically perfected security interests granted by brokers or intermediaries are subordinated to security interests perfected by control.[327] It thus made sense for the Article 9 drafters to try to structure the choice of law rules so that the law of the jurisdiction resolving the dispute did not elevate automatic perfection to a higher level of priority than permitted in Article 9. However, it is doubtful if bifurcation at the choice of law level is an effective way to deal with what is really a concern with the substantive disharmony in priority policy.[328]

In fact, the bifurcation approach in the UCC is not uncontroversial; it has been observed that "[i]n principle, it is bizarre to separate the issue of perfection from its priority effects."[329]. This criticism has been put forward in relation to tangible collateral. In that case, the perfection requirement is typically filing and the purpose of the filing regime is to give third parties information about their priority rights.[330] Professors Cuming and Walsh have therefore argued, in a Canadian context, that the value of the perfection requirement as such becomes questionable if the law governing perfection is separated from the law governing priority.[331]

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[325] *Ibid.* at 1247. See also Bjerre: International, *supra* note 233 at 279 who points out that the distinction sometimes is difficult to make even in national transactions within the US.

[326] Cohen & Smith: International Secured Transactions, *supra* note 281 at 1205

[327] See UCC § 9-328

[328] See Kuhn: Multi-State, *supra* note 242 at 1024 ff.

[329] Cuming, R.C.C. & Walsh, C., "Revised Article 9 of the Uniform Commercial Code: Implications for the Canadian Personal Property Security Acts" (2000-2001) 16 B.F.L.R. 339 at 361. This article provides a substantive criticism of the bifurcation from practical and conceptual reasons. For more, see pp. 357-362.

[330] *Ibid.* at 362

[331] *Ibid.*

However, under the UCC filing is a secondary means of perfection when it comes to indirectly held securities and bifurcation only applies in cases of automatic perfection, i.e. when attachment is sufficient to create the priority right. The concern that requirements for perfection and priority should be governed by the same law is therefore not as strong. Since third parties already are unable to consult public records to determine their priority status, the effects of bifurcation are therefore less worrisome, at least in an internal US conflicts context.

4.5 Conclusion

Notwithstanding the minor differences between the UCC and the Hague Convention highlighted above,[332] there is a fairly widespread international consensus about how choice of law issues should be resolved in the context of indirectly held securities. Different views are found concerning issues of detail, but agreement prevails as to the general principles.

The wide-spread support for PRIMA is the natural corollary of the development of the IHS and the rules pertaining thereto. PRIMA effectively abandons the idea that the location of the actual securities certificate is of any importance, and focuses instead on the relationship between an investor and his or her intermediary, a relationship that is of paramount importance in the IHS and in day to day dealings with investment property.

Market forces have had a great impact in the area of choice of law as with substantive law. This has led to a great expansion in party autonomy at the choice of law level, which may jeopardize the interests of third parties.

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[332] See section 4.4 above.

No matter how effective the choice of law solutions one is able to fashion for the problems posed by international transactions, those rules would be superfluous in the absence of domestic differences in substantive law. Uniform substantive rules would achieve more than uniform choice of law rules in terms of predictability and clarity.

5. RE-PLEDGE IN THE EUROPEAN UNION

This section will highlight some of the work that is being undertaken in the EU towards the integration and efficient functioning of the financial markets including re-pledge. The discussion will first describe the general concerns and objectives that have been put forward in striving for a more integrated financial market within Europe. The next section will touch on recent legislation on settlement among major institutions, aimed at reducing systemic risks. The bulk of this section is the third part, which describes the Collateral Directive and regulation of re-pledge therein.[333]

5.1 An Integrated European Financial Market

At its meeting at Lisbon in March 2000 the European Council set a strategic goal, to be achieved by 2010, to make the EU "the most competitive and dynamic knowledge-based economy in the world".[334] A paramount factor in achieving this goal is said to be the creation of a more integrated financial market, which is believed would lead to

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[333] The treatment of choice of law issues under the legislative acts that will be discussed below has already been mentioned in section 4.3.3.

[334] Report by the Economic and Financial Committee (EFC) on EU Financial Integration, No 171 – May 2002, ECFIN/194/02-EN [hereinafter EFC Report] at 3. Available on the internet at: http://europa.eu.int/comm/economy_finance/publications/economic_papers/2002/ecp171en.pdf (visited July 25, 2002).

growth in all economic sectors and to enhanced productivity.[335] Divergent national laws are currently creating uncertainties and impeding the achievement of this goal.

For the financial market, integration will presumably create greater efficiency and produce a market which is large, diversified and competitive.[336] An integrated market is expected to bring with it lower costs of borrowing and higher return rates for investors, due to the increased competition among providers of financial services.[337] It is also believed that the increased competition will lead to more innovation in the market and to the creation of new and diverse financial services, which would provide customers with a larger array of products to choose from.[338] After integration, it is presumed that the European market would be deeper and more liquid and the costs of capital and transaction costs would then be driven down and investors' returns increased.[339]

5.2 The Settlement Finality Directive

The efforts to integrate and improve the market must be accompanied by an appropriate framework for regulation and supervision to help control systemic risks.[340] The Settlement Finality Directive[341] (the 'SFD') was born out of the concerns with the systemic risks that are created in an environment where there are several legal types of payment netting, both with regards to payment settlement systems and systems for settlement of securities transfers.[342]

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[335] *Ibid.*
[336] *Ibid.* at 10
[337] *Ibid.*
[338] *Ibid.*
[339] *Ibid.*
[340] *Ibid.*
[341] See *supra* note 306. The SFD was adopted in May 1998 and was to be implemented by all member states before December 11, 1999.
[342] SFD Whereas-clauses (1) and (2).

The SFD applies on a high tier level of the market: to the central banks of the member states, the central settlement systems in the member states and other participants in those systems (Article 1). Such other participants are settlement agents, clearing houses and major institutions such as investment firms, credit institutions and public authorities.[343]

Netting between market participants decreases systemic risk since it reduces the outstanding obligations of each participant, thus alleviating the negative effects if one participant fails. It also contributes to efficiency since it dramatically reduces the number of transfers that must be undertaken between participants to settle the trades of a particular day. One of the main features of the SFD is to ensure that netting of obligations between the participants resulting from transfer orders is enforceable and that such netting is binding on third parties even in bankruptcy (Article 3(1)). The member states are also, under Article 3(2), prohibited from maintaining or enacting bankruptcy avoidance laws that would unwind any netting that has taken place prior to an insolvency proceeding. Further insulation against the effects of insolvency is provided by Article 7, which prohibits insolvency proceedings from having retroactive effects on rights and obligations arising from participation in a system.

Article 9(1) of the SFD protects the participants in the system from the bankruptcy of a collateral provider when they are holding collateral. The rights of a collateral holder cannot be affected by the commencement of insolvency proceedings against the provider and that the secured party is expressly entitled to realize the collateral for the satisfaction of its rights.

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[343] See SFD Article 2 which contains the relevant definitions.

It is evident that the SFD has had a great impact on the settlement and transfer systems in Europe; it is referred to as "...a milestone in establishing a sound legal framework for payment and securities systems.".[344] The risks facing the participants in the systems are clearly more manageable when the value of such tools as taking collateral as security and netting can be assessed with certainty at the outset.

However, the SFD is not applicable to the smaller market players. Their interests, at least as regards providing collateral, are the subject of the recently adopted Collateral Directive.

5.3 The Collateral Directive

5.3.1 Objectives of the Collateral Directive

Five major objectives have been identified as underlying the Collateral Directive[345] (the 'CD').[346] Firstle, the CD aims at creating effective and simple perfection rules for creating security interests in securities. As regards indirectly held securities, the perfection requirement shall be registration with a relevant intermediary. Secondly, it shall provide limited protection from some aspects of insolvency law, such as avoidance rules and laws prohibiting netting. The third objective is to provide legal certainty as regards choice of law issues. Fourthly, the use of collateral shall be simplified by restriction of onerous formalities. Finally, the CD shall ensure that agreements allowing

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[344] Collateral Directive Proposal, *supra* note 307 at 2
[345] See *supra* note 307
[346] Collateral Directive Proposal, *supra* note 307 at 4 f.

re-pledge are recognized. Re-pledge is believed to increase liquidity in the market and thus contribute to the overall goal of driving down costs and increasing profits.[347]

5.3.2 Applicability and Scope

A. Collateral

The CD is concerned with 'financial collateral', a term which is defined as cash or financial instruments.[348] In turn, 'cash' is defined as money credited to an account in any currency, and 'financial instruments' are defined as shares, debt instruments or other securities.[349]

'Book entry securities collateral' is defined as collateral consisting of financial instruments to which title is evidenced by entries in an account or register of an intermediary.[350] This last definition makes it clear that the CD does not distinguish between certificated and uncertificated securities.

B. Transactions

The transactions covered by the CD are 'financial collateral arrangements'.[351] That term encompasses both the provision of collateral under a secured lending arrangement, in which case full title to the collateral remains with the collateral provider, and title transfer arrangements for the purpose of securing outstanding obligations, such as repos.[352] Article 6 explicitly states that the member states must ensure that title transfer arrangements are effective in accordance with their terms, and that any obligation outstanding under such an arrangement may be closed out by netting upon the occurrence

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[347] CD Whereas-clause (19)
[348] CD Article 1(4)
[349] CD Article 2(1)(e)
[350] CD Article 2(1)(g)
[351] CD Article 1(1)

of an enforcement event. The formal efficiency of title transfer arrangements is further protected by a statement in the recitals prohibiting their re-characterization as security arrangements.[353]

Title transfer arrangements were included in and explicitly protected by the CD out of the fear that re-characterization would unsettle transactions in cases where the perfection requirements for title transfer arrangements and traditional secured transactions were different.[354]

C. Market participants

The CD applies to participants at lower tiers in the financial hierarchy than is the SFD. Article 1(2) enumerates the categories of market participants that both the provider and taker of collateral must belong to for the CD to apply: public authorities, central banks, financial institutions under regulatory supervision and settlement agents and clearing houses. Other legal persons are also included (hereinafter referred to as 'general business entities'), but transactions involving two general business entities are excluded. The member states also have the option of excluding transactions involving one or more than one general business entity from the scope of the CD.

Natural persons are excluded altogether. The re-pledge regime in the CD,[355] has therefore a narrower scope than the corresponding regime in the UCC. However, even though natural persons are not included, general business entities include unincorporated firms and partnerships. This means that natural persons can engage in re-pledgeable

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[352] CD Article 2(1)(a) through (c)

[353] CD Whereas-clause (13)

[354] Collateral Directive Proposal, *supra* note 307 at 8. It was earlier explained, in section 3.3 above, that some modern financial arrangements are difficult to characterize since the question of the property rights held or retained in indirectly held securities is equally unclear, in particular the right to redemption and the content of that right.

[355] See section 5.3.3 below

transactions through the use of unincorporated business vehicles which, in general, do little to shield personal assets from business creditors.

The CD does not apply to the rights of the collateral provider with respect to the collateral, other than the rights arising under the financial collateral arrangement.[356] Contractual issues between the holder and its intermediary and between the holder and the issuer are thus excluded.[357]

5.3.3 Re-pledge under the Collateral Directive

The CD uses the term 'right of use' to describe re-pledge. 'Right of use' is defined in Article 2(1)(m) as follows:

> 'right of use' means the right of the collateral taker to use and dispose of financial collateral provided under a security financial arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement

The right is thus limited to whatever rights have been granted by the Pledgor in its agreement with the Secured Party. This is also reflected in Article 5(1) which states that member states shall, "to the extent that the terms of a security financial collateral arrangement so provide", ensure that the collateral taker is entitled to exercise that right. Some member states currently allow re-pledge only if the right of redemption is not impaired, whereas other member states recognize arrangements under which the Secured Party is able to use the collateral as if it were the owner.[358] The CD attempts to accommodate these two approaches within a single statutory regime.[359] The CD is thus not as far-reaching as the UCC, since it does not establish a statutory right of re-pledge

[356] CD Whereas-clause (6)
[357] The choice of law rules of the CD have been mentioned in section 4.3.3 above.
[358] Collateral Directive Proposal, *supra* note 307 at 8

for Secured Parties. Nevertheless, the implementation of the CD may require changes in national legislation in the case of member states that previously recognized re-pledge by Secured Parties only when they were in fact acting as owners.

Two paragraphs of Article 5 are aimed at protecting the Pledgor. Under Article 5(2), the Secured Party, when effectuating a re-pledge, incurs an obligation to transfer equivalent collateral to the Pledgor's account at the latest on the due date of the Pledgor's obligation (subparagraph 1). This is obviously intended to preserve the Pledgor's right of redemption. The member states can alternatively implement rules to the effect that the Secured Party's obligation to provide equivalent collateral can be replaced by an obligation to set off the value of the collateral against the Pledgor's outstanding obligation or apply the value of the collateral in discharge of that obligation (subparagraph 2). The set-off alternative, however, only applies to the extent provided for in the security agreement.

These provisions are similar to the ones in Section 8-504 of the UCC, which likewise obligates securities intermediaries to maintain securities in a corresponding amount to the holdings of their customers. However, there are differences between UCC Section 8-504 and CD Article 5(2). The intermediary under the UCC is obligated to maintain corresponding books at all time, not just when the customer's outstanding obligation falls due. Also, the customer is able to wave the requirement by allowing a re-pledge that results in a deficiency with the intermediary.

Moreover, the explicit recognition of a right of set-off in the CD is not found in the UCC. Set-off is normally advantageous to the Pledgor. A right of set-off is a sort of

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[359] *Ibid.*

'quasi-security' which in many cases increases the value of the Pledgor's redemption claim.

A right to set-off is similar to having security since it provides priority; it is of course especially important for the Pledgor to have this protection when the Secured Party is in financial difficulties. Unless the Pledgor has some specific interest in retrieving the exact same securities that were pledged, there seems to be no reason why set-off would be an unacceptable alternative. In addition, set-off can only be executed, under the CD, when the Pledgor's obligation comes due. The Secured Party is therefore unable to manipulate value fluctuations to the detriment of the Pledgor's interests during the term of the obligation. In addition, the text of the CD, reasonably interpreted, provides for set-off at the Pledgor's will, which also enables the Pledgor to protect its interests. The main point is that the CD explicitly requires the Secured Party to respect the Pledgor's right of redemption, whether through replacement collateral or discharge of the Pledgor's obligation.

The second Pledgor protection rule is found in Article 5(5), which protects the right of set-off in cases where an enforcement event occurs while the Secured Party's obligation to provide equivalent collateral as required in Article 5(2), subparagraph 1 is outstanding. That obligation may then be the subject of a close-out netting provision.

Pledgors' interests are also protected by the recitals, which state that the CD applies without prejudice to any national law on separation of assets,[360] at least in the case of jurisdictions where holders in the IHS are awarded full, traditional property rights. An important aspect of that property right is that it enables the owner to extract its property from the estate of the Secured Party. The concept of ownership is closely related to the ability to identify and distinguish the object or interest owned.[361] Rules requesting intermediaries to keep separate and identifiable the assets of customers will thus preserve the customers' ability to enforce their property rights by extracting their assets.

The interests of Secured Parties are protected by Article 5(3) which deals with the right to substitute collateral and with the effects of national avoidance provisions. It provides that any equivalent collateral given in fulfillment of the replacement obligation under Article 5(2) shall be subject to the same security interest in favor of the Secured Party as the original collateral. Moreover, the replacement collateral is treated as if it had been provided at the same time as the original collateral. The purpose of this last provision is to avoid the application of bankruptcy avoidance laws which are directed at grants of collateral which take place after the obligation to be secured was incurred. Some jurisdictions regard that type of transaction as avoidable since the lender has required collateral only at the point when the debtor is approaching insolvency. Providing that creditor with priority is thought to be unfair since it upsets the expectations of third parties who entered the picture when the debt was incurred or who subsequently became creditors. Bankruptcy proceedings are intended to unwind the debtor's affairs for the benefit of all unsecured creditors; it is unacceptable that one creditor 'goes to the front of the line' just because insolvency is imminent. The schemes for priority and sharing established by bankruptcy law would then be undermined.

Insulation against the effects of national bankruptcy legislation is also provided by Article 8, which directs the member states to make certain of their insolvency provisions inapplicable to financial collateral arrangements. Article 8(1) states that

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[360] CD Whereas-clause (19)

[361] See section 3.1.3 above.

arrangements that have come into existence, or collateral that has been provided, in a specified period of time prior to the commencement of insolvency proceedings may not be avoided solely on that ground. Article 8(3) protects so-called top-up financial collateral agreements, under which the Pledgor is required to provide additional collateral if the value of the existing collateral declines.[362] The efficiency of a subsequent provision of collateral under such an agreement would of course also be at risk due to the avoidance rules mentioned in the last paragraph.

Finally Article 4(6) states that certain articles in the CD, among them Article 5, operate without prejudice to national legislation requiring the realization or valuation of financial collateral to be conducted in a commercially reasonable manner. This reservation could presumably affect all three parties involved in a re-pledge. For example, some regimes might require a Re-pledgee, if aware that the collateral provided is owned by the Pledgor, to take the Pledgor's interests into account when realizing the security interest against the Secured Party.

5.4 Re-pledge under the UCC and the Collateral Directive

A full comparison between the rules regulating re-pledge in the UCC and the CD would be somewhat awkward, since the UCC rules on the subject are far more comprehensive. Nevertheless, a few differences will be mentioned.

First, the scope of the rules is different. The UCC applies to any provider of collateral whereas the CD excludes natural persons altogether. This leaves issues of consumer protection outside the scope of the CD; this exclusive focus on transactions

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[362] CD Whereas-clause (16)

between sophisticated market participants was arguably designed to enable the EU to adopt more 'aggressive' rules. However, this has not been the result.

On the contrary the rules in the CD are more protective of ownership rights than the UCC (over and above the fact that they require the consent of the Pledgor to a re-pledge). Re-pledges under the CD are allowed only to the extent they do not impair the Pledgor's right to redemption. National legislation concerning separation of assets is also preserved, which contributes to the protection of ownership rights.

This greater focus on traditional property rights can presumably be explained on two grounds. First, the CD must be implemented in a number of different countries, including common law as well as civil law jurisdictions, with diverse and differing legal concepts and policy backgrounds. The UCC operates in a different environment, partly because its widespread implementation in the 1960s already producing significant unification of commercial law within the US. Also, the UCC operates within a fairly homogenous setting of US states that share a common background in the British common law (Louisiana excepted). The EU does not, at least at present, regulate the property laws of member states and the CD therefore had to accommodate national interests and particularities. The drafters of the UCC were therefore able to implement more radical reforms than their European counterparts, including the current rules on re-pledge in the UCC, which arguably dispense with traditional notions of ownership. For such changes to be made in the EU, its development towards 'the United States of Europe' would have to be further along than it is at present.

Second, many of the member states within the EU are civil law countries. Civil law jurisdictions have traditionally been more protective of property rights than the common law, and the civil law has more explicitly recognized the distinct in rem character of property rights.[363] Member states would therefore have been more uncomfortable with granting a right to re-pledge that jeopardized the right of redemption and it is not surprising that the EU has not embraced as potent a right of re-pledge such that found in the UCC.

Interestingly, bank deposits are included in the CD. The rules on secured transactions in the UCC also apply to the use of deposit accounts as collateral, at least when the Pledgor is a non-consumer.[364] However, Secured Parties holding deposit accounts as collateral may not re-pledge them, as evident from the exclusion in Section 9-207(d)(2).[365] No similar exclusion is found in the CD.

The differences in the legal treatment of deposit accounts and securities accounts already were discussed and it was noted that property rights are traditionally accorded in the latter but not the former.[366] The rules on re-pledge in the CD make no distinction between re-pledges that involve cash collateral and those that involve collateral in the form of securities. This may be explained by the fact that holders of deposit accounts have no property rights in the money in the account, and that banks often have no need to take security in accounts they hold, since they are adequately protected by their right to set-off with respect to the funds in the account.

But, if the Secured Party is someone other than the bank, a re-pledge of the collateral would generally be prohibited unless the Pledgor consented thereto. The

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[363] Merrill & Smith, *supra* note 102 at 358 f. and 385 ff. where they discuss the *numerus clauses*-principle and its effect on the concept of property.

[364] § 9-109 and Official Comment 16 thereto.

[365] The exclusion is explained by Official Comment 7 to § 9-207 by the fact that any right to 're-pledge' by a buyer of deposits is preferably treated by other law than the UCC.

[366] See section 3.4.6 above.

Pledgor has then pledged the right in his or her claim against the bank. This claim then effectively becomes an item of property which, under the CD, may be re-pledged if the Pledgor consents thereto. The Pledgor would be protected by the right of redemption, which is well preserved in the CD. A right to redeem a bank deposit that has been pledged is conceptually possible since the res in the transaction is the bank's payment obligation and not the inherently fungible units of money that originally were deposited in the account. The Pledgor's redemption interest is the right to be re-assigned the bank's payment obligation, not to receive the precise money that was first deposited in the account, a practical and conceptual impossibility.

Despite differences with the UCC and the CD, the fact that the EU has provided for re-pledge in the CD shows that there is a widespread international consensus on its usefulness. It also provides further evidence that the practices of the market to a very high degree dictate the content of modern legal regimes. The EU documentation makes recurring references to the fact that the developments in this area are market driven and that one of the major objectives is to satisfy market needs.[367] It is therefore likely that a more comprehensive commercial law regime in Europe, if and when increased integration of the legal and financial systems takes place, will continue to resemble the UCC.

6. CONCLUDING REMARKS

This paper begun with a description of the structure of modern securities markets. We saw that current holding patterns have come a long way from the traditional structure

[367] See for example CD Whereas-clause (16), Collateral Directive Proposal, *supra* note 307 at 5 and EFC Report, *supra* note 334 at 3.

in which owners of securities received elaborately designed paper certificates which they carefully stored in their safety deposit boxes. Ownership of securities has become dematerialized and is increasingly evidenced merely by book-entries in accounts maintained by intermediaries. Consequently, the mode for transferring ownership and other interests in securities has changed from physical delivery to entries on electronic records. As we have seen, this practical restructuring has, in turn, had an enormous impact on traditional concepts of property rights in securities.

The modern holding system – the IHS – was developed as an answer to the back office crisis that the financial world experienced in the 1960s. The policy choices underlying the IHS largely centered on satisfying the demands of the larger institutions in the markets and the interests of individual investors were given secondary consideration. The prevailing theory seems to have been that general prosperity will be achieved if the large institutions are supported and that all market participants, big and small, will ultimately benefit from that support.

This focus on the financial institutions, which in most cases are brokers or dealers, is clearly evidenced in the legal rules setting out the property rights of securities investors in the HIS developed by the drafters of the UCC in the US. It has been shown that priority almost invariably is accorded to buyers over owners and to higher tier participants over those at lower rungs in the hierarchy. The differences between this concept of property in the IHS as reflected in the UCC and traditional notions of property and ownership also have been identified. It was further observed that this development is in line with contemporary scholarly ideas about property and responds well to the demands of the markets. We have, moreover, seen that property in modern scholarship has lost some of its traditional distinctive features and instead has become a very flexible and loose concept, used to denote almost any type of relationship between competing claimants. The traditional notions of ownership as relating to distinct, identifiable objects, and corollary principles such as following, have been dismissed as outdated and practically impossible or cumbersome. Investors in the IHS are expected to rely on the integrity of their intermediaries, rather than any inherent property rights.

Reliance on the solvency and integrity of the intermediary as a substitute for a strong substantial property right is also evidenced in the UCC rules pertaining to re-pledge, where the Re-pledgee is likely to win any priority dispute. The Pledgor's best hope is therefore that a priority dispute never arises, i.e. that the Secured Party remains solvent. If it does not, the Pledgor's interests are very vulnerable.

The UCC policy on re-pledge is consistent with the overall policy of the UCC to promote secured lending, so as to enhance market efficiency. This positive view of secured lending is not undisputed and some of the debate relating to that issue has been reviewed. We have seen, however, that Article 9 of the UCC remains wedded to the protection of secured lenders and enhancement of their rights.

One of the main recurring themes in this paper has been that the property rights of holders in the IHS are quite different from more traditional concepts of property to a degree that makes it problematic to label these rights as 'property' at all. Ideally, they should be given a new and different name that more honestly describes the true nature of the holders' interests. That would be beneficial for a number of reasons. Not only would securities investors be more knowledgeable about the true nature of their rights, but the concept of property in the legal regime as a whole would also be preserved. Property traditionally contains at least three core concepts and those core concepts must be protected if property is to be able to effectively perform the tasks assigned to it by a legal system. We have seen that these tasks are to allocate resources among competing claimants and to provide for contractual exchange of those resources. In particular, concepts of property underlie the practice of secured lending since the divisibility of property enables owners to provide lesser interests to secured parties and still retain the superior interest that is 'ownership'. This ranking of the different interests is naturally of paramount consequence for those engaging in secured transactions.

This observation leads us to the important distinction between secured transactions and true sales that has also been discussed in this paper. This distinction is to a large extent dependent on what property rights the owner retains after the transaction. If these rights are too insubstantial, the transaction should rightfully be regarded as a sale, since the owner has alienated the significant property interests in the assets. It is important that parties be able, at the outset, to characterize correctly their transaction. The general conceptual legal framework also benefits if distinct concepts are preserved to denote distinct transactions. In other words, what in substance is a sale should be denoted as such and the concept of secured transactions should not be stretched beyond its natural borders. The determining factor must always be the actual effects and function of a transaction, not the formal label given to it.

The UCC developments are not peculiar to US conditions. The various projects presently being undertaken by the Hague Conference and the EU demonstrate that the UCC reflects an international trend. We have seen that these institutions take the changing market realities into account and display deference to market needs in much the same way as the UCC does in a US context.

A noteworthy change found internationally as well as in the US, is the abandonment of the traditional lex situs-rule for choice of law in this area in favor of the jurisdiction of the intermediary. This change is a natural consequence of the fact that the physical certificate has lost its paramount importance as the traded object. The rights and obligations of holders and intermediaries, and buyers and sellers are today 'located' in intermediaries' accounts, and it would be illogical to resolve issues concerning choice of law based on any other criterion. However, in ascertaining the location of the intermediary, it was noted that party autonomy has become permissible even for proprietary aspects, a far more radical development.

This paper has shown that there is a fairly widespread international consensus regarding the structure and the legal rules for holding systems as well as the regulation of re-pledge transactions. Even though the rules in the UCC are more far-reaching, the EU rules also expressly endorse the use of re-pledge. The two legal systems also share an underlying commitment to secured lending and a desire to implement rules that are supportive of secured creditors. However, the EU has excluded natural persons from its regulation of re-pledge. This arguably shows that European legislators are more concerned with the impact that reduced property rights may have on individual investors, than are their US counterparts.

The current legal deference to market realities is likely to continue undiminished and, consequently, the current trend favoring indirect and dematerialized holding patterns is likely to become the general norm if it has not already become so. This paper has shown that this trend has significantly eroded traditional ideas of ownership and property. Despite the negative impact on the overall coherence of private law systems, realistically there seems to be no going backwards. If this is the case, the law needs to abandon traditional property-language and develop a 'new' category of property-related personal obligations. Whether this will be done in the near future is uncertain. The market may resist, fearing the psychological impact on investors if they are told the truth: that they do not in fact own their securities in any real sense of that term.

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