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New York Law Journal

Corporate Update

SECURED TRANSACTIONS

Securities and Securities Intermediaries: How Secure Are Intermediated Holdings?

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December 5, 2024

As a result of increased trading volume dating back to the 1960s, when paperwork backlogs temporarily derailed Wall Street, as well as the growth in technology, the securities trading industry has come to rely heavily on a system of indirect ownership of securities. Most investors now hold their securities through bank or brokerage accounts, and those banks or brokers will likely, in turn, hold those securities through a central securities depository, such as The Depository Trust Company (DTC). While the intermediated holding system has resolved many problems associated with the growth in trading volume, there have been some recent thoughts and developments regarding this system that require careful consideration.

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First, in May of this year, and then in late August, a task force formed by certain members of the American Bar Association Business Law Section issued, respectively, Part One and Part Two of its Final Report on the Work of the Task Force on Securities Holding Infrastructure (each of which is available at www.americanbar.org[1]; note that the Report represents only the views of the

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1 https://www.americanbar.org/groups/business_law/resources/business-lawyer/2024-spring/final-report-on-the-work-of-the-task-force-on-securities-holding-infrastructure and https://www.americanbar.org/groups/business_law/resources/business-lawyer/2024-summer/final-report-on-the-work-of-the-task-force-on-securities-holding-infrastructure

co-chair authors of the Report and not those of the American Bar Association, or any members of the Business Law Section, the task force or any of their respective firms or clients).

The Report identifies certain concerning issues for securities investors which the task force sees as inherent in the system of intermediated holding of securities. (Some of these issues were illustrated in a recent case (the "UMB Bank case") in front of a New York Federal District Court (*UMB Bank, N.A. v. Bristol-Myers Squibb Co.*, No. 21-CV-4897, discussed briefly below).

Second, in the week following the issuance of Part Two of the Report, the Uniform Law Commission released its "Statement on Ownership of Investment Property under Uniform Commercial Code Article 8" (available at uniformlaws.org[2]) (the ULC Statement). The ULC Statement responds to several state legislative efforts to address perceived concerns that UCC Article 8 does not sufficiently protect investors in the event of insolvency of a securities intermediary (i.e., the bank or broker holding securities on an investor's behalf).

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Of course, the above reflect the complex regulatory structure of the holding system, characterized by an intersecting mix of both state and federal law. Federal and state securities laws regulate the issuance, sale and resale of securities and the conduct of broker-dealers in the securities markets. Those work in tandem with UCC Articles 8 and 9, which provide additional state law protections from a private commercial transaction perspective.

It is these issues, and the arguments for and against them, that are discussed in today's column.

Intermediated Holding

The system of intermediated holding was developed in response to challenges posed by the prior system of direct holding. In that direct holding system, investors, for the most part, held physical certificates representing their property interest in securities. The investor was named as the registered owner of the security on the issuer's books.

By contrast, the intermediated holding infrastructure places institutions—securities intermediaries and, usually for publicly-traded corporate debt and equity securities, DTC — between the issuer and the investor. Investors own their securities through a securities account held with an intermediary (e.g., their broker or bank) and the vast majority of publicly-traded debt and equity securities themselves are held on deposit with DTC.

A DTC nominee, Cede & Co., is listed as the registered owner of the securities on the issuer's books. While this system does allow for electronic book-entry clearance and settlement via a clearing corporation, thereby expediting the securities transfer process, the multi-layered ownership and transaction structure creates potential issues for market participants post-settlement. This is due in large part to the fact that the investor has no privity with the issuer and is not the registered owner of the securities that the investor in fact owns.

The Task Force Report

Part One of the Report identified what the authors viewed as key issues with the intermediated

[2] https://higherlogicdownload.s3.amazonaws.com/UNIFORMLAWS/b7c515db-1895-4387-bb2d-ee99e58c0066/UploadedImages/Documents/ULC_Statement_on_Ownership_of_Investment_Property_under_UCC_Article_8-Sep_2024.pdf

holding infrastructure, with Part Two suggesting potential fixes to such issues. Ultimately, however, the Report does not formally recommend specific changes to the system.

Instead, its overarching recommendation is for “the organization, completion, and widespread dissemination of an independent and thorough study, including a benefit-cost analysis, of the current securities holding infrastructure.” Such a study “should make recommendations, if any, concerning the plausible means of addressing the problems discussed,” should be “undertaken by an independent entity… such as an established and impartial research organization,” and be “commissioned or sponsored by a governmental entity, such as the SEC.”

According to the Report, the first issue causes problems for investors when voting their securities and enforcing other security-holder rights. The Report cites as an example the complex and expensive “proxy plumbing” process that must be undertaken whenever investors want to vote their shares – a situation that has been studied extensively by the Securities and Exchange Commission for decades (with virtually no implemented reforms).

The Report focuses generally on two key issues within the current infrastructure. The first relates to the lack of privity between, and lack of transparency regarding, the various parties in an intermediated securities relationship; the second relates to possible imbalances between the number of securities credited to an investor’s security account and the number of securities in which the investor actually has a property interest.

According to the Report, the first issue causes problems for investors when voting their securities and enforcing other security-holder rights. The Report cites as an example the complex and expensive “proxy plumbing” process that must be undertaken whenever investors want to vote their shares – a situation that has been studied extensively by the Securities and Exchange Commission for decades (with virtually no implemented reforms). It notes that these impediments similarly present challenges to investors when seeking to exercise remedies or other basic security-holder rights. According to the Report, the added complexity from interposing securities intermediaries in the ownership structure results in multiple channels of communication, additional documents, and added expense for all involved.

The second issue relates to what the authors refer to as “imbalances” in securities accounts. According to the Report, oftentimes, and as a routine matter, imbalances may occur in securities accounts, typically because of the repledging of securities by broker-dealers in connection with margin loans as well as repurchases (i.e., a repo). These transactions could cause broker-dealers to show securities credited to a beneficial owner’s account that exceed the number of such securities the intermediary holds for such account.

While any shortfalls are addressed by SEC rules, including its customer protection rules, and SIPC coverage, nonetheless the amount of securities credited to investor accounts remains the basis for the determining shareholder votes and rights to approve or disapprove corporate actions or undertakings – so, voting results could theoretically be skewed if related intermediaries actually hold fewer shares than are voted.

To address these two issues, the Report outlines three potential “approach[es] to transparency.” The first approach, which the Report calls “synthetic transparency,” leaves the current structure basically intact but would improve the information flow among the holding structure participants in order to "identify, track, and reconcile" beneficial ownership of investors in securities. The Report suggests that a "standing, ongoing information network" might be developed in place of the current ad-hoc model, which springs up only when an investor wishes to exercise its rights and relies heavily on DTC's administrative capabilities.

The second approach—which the Report calls "the structural transparency model"—would involve more fundamental changes to the current infrastructure. This model would require information reporting as an integral part of the DTC-NSCC settlement and post-settlement process system. Information as to the identity of securities investors would be updated real-time, or at least daily. Notably, neither of the models would necessitate providing information regarding beneficial ownership to any person or entity not already entitled to receive it.

Per the Report, the two models are functionally identical, and both would facilitate the exercise by investors of their rights by, for example, enabling beneficial owners to receive proxies or enforce rights directly, as well as reducing errors and expense in the communication and solicitation processes. Both models would also fix the routine imbalances described above by ensuring that shareholder elections and approvals more accurately account for beneficial ownership. It does note, however, that a methodology for accounting for the routine imbalances would need to be developed and implemented in either case.

The Report's third and final suggested approach would be to adopt a direct holding model in which investors hold their securities directly on the issuer's books. The Report suggests that "implementing the direct-holding model could be less complicated and more straightforward than putting in place either of the transparency models."

According to the Report, this would largely be due to the removal of the multi-layered process of communication and investment reconciliation necessitated by the current infrastructure, even where an investor wishes to remain anonymous and be represented by a nominee on the issuer's books. The Report concedes that reversion to direct holding might face challenges, including potential legal and regulatory upheaval, as well as the need for "an "operator," at least in some form," to remain interposed in the infrastructure for synthetic securities accounts.

The Report notes that "there is strong evidence that support for such infrastructure reforms exists within the securities industry," but goes on to suggest that any major reforms to the current intermediated holdings infrastructure could also face "strong opposition" from the beneficiaries of that infrastructure.

The recent UMB Bank case first mentioned above illustrates some of the problems of the indirect holding system when investors desire to exercise security-holder rights. In that case, a US District Court held that a trustee seeking to represent owners of beneficial interests in contingent value rights (CVRs) issued by Bristol-Myers Squibb Company had not been properly appointed. *See* Opinion & Order, 2024 WL 4355029, at *8 (S.D.N.Y. Sept. 30, 2024). Notably, the CVR agreement required *registered holders* of the CVRs to appoint a new trustee. However, the only registered holder of the CVRs was Cede & Co., and the trustee and beneficial owners had failed to involve DTC in effecting that appointment.

The ULC Statement

As noted above, concerns have also recently been raised about the indirect holding system in the context of UCC Article 8, in this case with respect to the risk of a broker-dealer or securities intermediary insolvency.

UCC §8-503(a) provides, as a general proposition, that all interests in securities held by a securities intermediary for its “entitlement holders” (i.e., investors) “are not property of the securities intermediary and are not subject to the claims of creditors of the securities intermediary.” There are two exceptions to this general rule, both of which are in UCC §8-511.

The first exception, most commonly applicable in the context of margin loans, is contained in UCC §8-511(b) and applies when an investor gives written consent to the pledge by its intermediary of its securities. In this scenario, Article 8 gives priority to the creditor who lends to an intermediary and obtains “control” over an investor’s securities as collateral for such loan.

The second exception, contained in UCC §8-511(c), is applicable to the secured creditors of clearing corporations. Article 8 prioritizes secured creditors who lend to clearing corporations, so that the clearing corporation will be able to draw on end-of-day liquidity facilities to settle a day’s trades, notwithstanding the failure of one of the parties to perform its obligations with respect to that trade.

Proposed revisions to UCC §8-511 have been introduced in several states, including Minnesota, Mississippi, North Dakota, South Carolina and Tennessee, intended to eliminate those exceptions. Legislators in these states are concerned that these exceptions might allow a securities intermediary’s creditor to seize securities in a retirement account if those securities were pledged by an insolvent intermediary.

However, the ULC Statement notes that any such pledge “would be both highly illegal, and as a practical matter, impossible” given that the Internal Revenue Code prohibits the pledge of securities held in a retirement account. Furthermore, Article 8 requires a securities intermediary to “obtain and thereafter maintain” securities in an amount at least corresponding to the amount credited to its investors’ accounts and, without the express consent of the entitlement holder, prohibits it from granting “any security interests in a financial asset it is obligated to maintain” (UCC §8-504(a)-(b)).

The ULC states that, if these two exceptions are removed from Article 8 and therefore investors *always* have priority claims in their securities, the availability of margin loans may be limited (if they remain available at all) and clearing corporations might cease doing business with intermediaries in states that have so amended Article 8. The ULC also believes that to remove this uniformity from Article 8 would result in “unnecessary legal expenses” and “additional complications” to routine securities transactions.

Conclusion

The Report identifies several key areas in which the current intermediated holding system might be improved to increase efficiency, clarity and precision for investors and other market participants. The Report’s suggested solutions range from subtle market changes to wholescale reworkings of the current infrastructure. It remains to be seen whether any of the approaches offered as possibilities by the Report will receive the institutional buy-in necessary to move them forward.

Similarly, the ULC Statement provides a rebuttal to the perceived dangers posed by the Article 8 exceptions and warns of the risks of deviating from the uniformity of the UCC in the context of intermediated holding. Only time will tell whether the ULC can persuade state legislators to abandon these proposed non-uniform changes.