

Appendix I

The New York Federal Reserve's reply to the EU Clearing and Settlement Legal Certainty Group's questionnaire

These are the key facts:

- Ownership of securities as property has been replaced with a new legal concept of a "security entitlement", which is a contractual claim assuring a very weak position if the account provider becomes insolvent.
- *All* securities are held in un-segregated pooled form. Securities used as collateral, and those restricted from such use, are held in the same pool.
- *All* account holders, including those who have prohibited use of their securities as collateral, must, by law, receive only a pro-rata share of residual assets.
- "Re-vindication," i.e. the taking back of one's own securities in the event of insolvency, is absolutely prohibited.
- Account providers may legally borrow pooled securities to collateralize proprietary trading and financing without restriction.
- "Safe Harbor" assures secured creditors priority claim to pooled securities ahead of account holders.
- The absolute priority claim of secured creditors to pooled client securities has been upheld by the courts.
-

The documentation is absolutely irrefutable. In March of 2006, the Deputy General Counsel for the Federal Reserve Bank of New York provided a detailed response to a questionnaire prepared by The Legal Certainty Group, which was established by The European Commission Internal Markets and Services Director General to address problems of legal uncertainty for secured creditors. The following are excerpts from that response (1):

Q (E.U.):

In respect of what legal system are the following answers given?

A (N.Y. Fed):

This response confines itself to U.S. commercial law, primarily Article 8 ... and parts of Article 9, of the Uniform Commercial Code ("UCC") ... The subject matter of Article 8 is 'Investment Securities' and the subject of Article 9 is 'Secured Transactions.' Article 8 and Article 9 have been adopted throughout the United States.

Q (E.U.):

Where securities are held in pooled form (e.g. a collective securities position, rather than segregated individual positions per person), does the investor have rights attaching to particular securities in the pool?

A (N.Y. Fed):

No. The security entitlement holder ... has a pro rata share of the interests in the financial asset held by its securities intermediary ... This is true even if investor positions are 'segregated.'

Q (E.U.):

Is the investor protected against the insolvency of an intermediary and, if so, how?

A (N.Y. Fed):

... an investor is always vulnerable to a securities intermediary that does not itself have interests in a financial asset sufficient to cover all of the securities entitlements that it has created in that financial asset ...

If the secured creditor has "control" over the financial asset it will have priority over entitlement holders ...

If the securities intermediary is a clearing corporation, the claims of its creditors have priority over the claims of entitlement holders.

Q (E.U.):

What rules protect a transferee acting in good faith?

A (N.Y. Fed):

Article 8 protects a purchaser of a financial asset against claims of an entitlement holder to a property interest in that financial asset, by limiting the entitlement holder's ability to enforce that claim ... Essentially, unless the purchaser was involved in the wrongdoing of the securities intermediary, an entitlement holder will be precluded from raising a claim against it.

Q (E.U.):

How are shortfalls [i.e. the intermediary's position with an upper-tier intermediary is less than the aggregate recorded position of the intermediary's account-holders] handled in practice?

A (N.Y. Fed):

... The only rule in such instances is that the security entitlement holders simply share pro rata in the interests held by the securities intermediary ...

In actual fact, shortfalls occur frequently due to fails and for other reasons, but are of no general consequence except in the case of the securities intermediary's insolvency.

Q (E.U.):

Does the treatment of shortfalls differ according to whether there is (i) no fault on the part of the intermediary, (ii) if fault, fraud or (iv) if fault, negligence or similar breach of duty?

A (N.Y. Fed):

In terms of the interest that the entitlement holders have in the financial assets credited to its securities account: regardless of fault, fraud, or negligence of the securities intermediary, under Article 8, the entitlement holder has only a pro rata share in the securities intermediary's interest in the financial asset in question.

That's how it works directly from the most authoritative source possible—lawyers working for the Fed.

1. Commission, E. (2005) [The New York Federal Reserve's reply to the EU Clearing and Settlement Legal Certainty Group's questionnaire.](#)