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GOOD FAITH TRANSFEREES OF U.S. TREASURY SECURITIES AND OTHER WEIRD IDEAS: MAKING FEDERAL COMMERCIAL LAW

*Charles W. Mooney, Jr.**

THE ANTEATER AND THE ANT: A LITTLE STORY

Several years ago I read a "B.C." comic strip that made a profound point. In the first two frames of the strip, an ant was skiing with obvious joy and abandon down steep, magnificent slopes. In the third frame the ant spoke: "This is my lucky day!" The fourth (and final) frame portrayed the frolicking ant from a more distant vantage, showing clearly that the hills on which the ant was skiing were a part of the long, extended tongue of an anteater.

I. INTRODUCTION

This Essay explains how the putative protection for "good faith transferees" of United States Treasury securities, contained in proposed Treasury regulations, is much like the anteater's tongue. The proposed protection is illusory and, far from being benign, could create substantial mischief in the marketplace. This Essay also offers some general observations about federal laws and regulations in the field of private commercial law.

Federal regulations issued by the Treasury Department govern transfers of interest—including security interests—in United States Treasury securities.[1] The Treasury Department proposed new regula-

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1. Treas. Reg. § 306.118 (1973) (Book-Entry Treasury Regulations). As amended, the Book-Entry Treasury Regulations cover book-entry Treasury bonds, notes, certificates of indebtedness and bills issued under the Second Liberty Bond Act. Treas. Reg. § 306.115(d) (as amended in 1973) (defining "book-entry Treasury security"). For similar regulations dealing with book-entry Treasury bills, see Treas. Reg. §§ 350.2-.5 (1976), -.6 (as amended in 1976). Virtually all Treasury securities are in book-entry—or uncertificated—form.

tions in March 1986,[2] and again in November 1986.[3] These proposals were motivated in large part by prevailing confusion concerning the appropriate resolution of conflicting claims to Treasury securities. To date, however, the Treasury Department has not issued new regulations in final form. During the years following these proposals, both scholarly legal commentary[4] and an American Bar Association committee,[5] in connection with securities in general, addressed many of the issues that gave rise to the proposed Treasury regulations. These efforts focused on the problems associated with applying current law to securities controlled by financial intermediaries, such as stockbrokers and banks. In the Treasury securities market, as in the securities markets generally, active participants must rely on intermediary control of securities.[6]

In 1991, inspired by ABA Committee recommendations, the National Conference of Commissioners on Uniform State Laws (NCCUSL) formed a drafting committee for the revision of UCC Article 8, which governs investment securities.[7] By the spring of 1992, the Article 8 drafting committee had prepared a draft of the revisions to be considered at the "first reading" before the NCCUSL membership.[8] That draft reflected an emerging consensus on several important points, including

2. Prop. Treas. Reg. §§ 357.0-.3, .10-.17, .40-.45, 51 Fed. Reg. 8846 (1986) [hereinafter March Proposed TRADES Regulations]. "TRADES" refers to the Treasury/Reserve Automated Debt Entry System.

3. Prop. Treas. Reg. §§ 357.0-.2, .10-.21, .42, .44, 51 Fed. Reg. 43,027 (1986) [hereinafter November Proposed TRADES Regulations].

4. *See, e.g.*, Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305 (1990); Jeanne L. Schroeder & David G. Carlson, *Security Interests Under Article 8 of the Uniform Commercial Code*, 12 CARDOZO L. REV. 557 (1990).

5. *See Interim Report of the Advisory Committee on Settlement of Market Transactions*, 1991 A.B.A. SEC. BUS. L. REP. (Exposure Draft).

6. An explanation of the structure and operation of the securities market is beyond the scope of this Essay. Suffice it to say that the intermediary-control phenomenon has arisen in large part from the structure of systems for clearing (comparing, matching and confirming trades so each party is assured that the trades have been made according to the mutually agreed upon terms) and settling (transferring interests in securities and paying for securities) securities transactions.

7. The NCCUSL also was prompted to action by the Market Reform Act of 1990, § 5, Pub. L. No. 101-432, 104 Stat. 963, 973-75 (amending § 17A(a)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q-1 (1988 & Supp. III 1991)). This legislation gives Congress the power to issue preemptive federal regulations concerning the transfer and pledge of interests in securities. *Id.*

8. *See* U.C.C. art. 8 (Tent. Draft May 1, 1992). The first reading took place in August 1992, in San Francisco. In October 1992, the drafting committee considered a further-revised draft, and in January 1993, the drafting committee considered yet another draft. *See id.* art. 8 (Tent. Draft Oct. 6, 1992); *id.* art. 8 (Tent. Draft Jan. 4, 1993). In my view, each of these drafts adequately responded to the critique contained in Mooney, *supra* note 4, and incorporated the substance of my principal proposals for reform.

many aspects of the priority contests that troubled the Treasury Department.[9] Notwithstanding this growing consensus, the Treasury Department issued yet another set of proposed regulations in April 1992.[10] Although the commentary to the 1992 Proposed Regulations acknowledges the Article 8 drafting committee's progress, the substance of the regulations ignores that progress.[11] In particular, the 1992 Proposed Regulations retain a "good faith transferee" rule that is wholly at odds with the draft revised Article 8's approach to conflicting claims to fungible bulks of securities controlled by financial intermediaries.

The next part of this Essay provides a brief sketch of how financial intermediaries in the United States markets trade, finance and control Treasury securities. Part III offers a critique of the good faith transferee priority rule that appears in the 1992 Proposed Regulations.

II. Book-Entry Treasury Securities and the "Tiered" System of Financial Intermediary Control

The Treasury Department has used the following example to describe the system of ownership of Treasury securities:

> Assume that an individual ("Individual Investor") has invested in a Treasury 5-year note through a local government securities dealer ("Local Dealer"). Local Dealer will be maintaining one or more Treasury 5-year notes of the same issue through another book-entry custodian such as a larger government securities dealer ("National Dealer"). National Dealer would, most

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9. U.C.C. art. 8 (Tent. Draft May 1, 1992).

10. Prop. Treas. Reg. §§ 357.0-.45, 57 Fed. Reg. 12,244 (1992) (amended by 57 Fed. Reg. 20,572 (1992)) [hereinafter 1992 Proposed Regulations].

11. *See id.* The supplementary background information to the 1992 Proposed Regulations provides:

> The NCCUSL Drafting Committee was formed this year and most recently met on October 25-27, 1991. Representatives from Treasury are attending these meetings. Given the fact that these proposed regulations rely a great deal on the principles in Article 8 of the Uniform Commercial Code, the Department is keenly interested in monitoring the progress of the NCCUSL group. Moreoever [sic], it would be desirable, ultimately, to have the same law apply to U.S. Treasury securities as applies to other securities, to the extent possible. At the same time, however, it should be recognized that Treasury, as an issuer of securities backed by the full faith and credit of the United States, has some unique concerns. In view of the length of time that this regulatory project has been pending, the Department has concluded that it would be of assistance to participants in the Government securities market to have the benefit of Treasury's most recent thinking, and also to have an opportunity to comment on the regulations in the context of other initiatives currently under way. Treasury continues, however, to be supportive of the efforts of the NCCUSL and other groups and welcomes the opportunity of joining in a critical examination of issues relating to the transfer and pledge of book-entry securities.

Id., 57 Fed. Reg. at 12,245.

likely, be maintaining the 5-year notes through a bank ("Clearing Bank"). Clearing Bank would be maintaining the 5-year notes directly in an account at a Federal Reserve Bank . . . . Each of the book-entry custodians [*i.e.*, Clearing Bank and National Dealer] will record on its books securities maintained for the account of the book-entry custodian below it in the chain [*i.e.*, National Dealer and Local Dealer, respectively], and Local Dealer will record on its books the interest of Individual Investor.[12]

The Treasury securities market depends on large amounts of intraday and overnight secured financing.[13] Consider the following three transactions arising out of the relationships described by the Treasury Department in the foregoing example:

(i) National Dealer (ND) extends credit to Local Dealer (LD). LD grants to ND a security interest in Treasury securities shown on LD's account with ND.

(ii) LD marks its books to reflect a transfer of Treasury securities to Repo Purchaser (RP); RP sends funds to LD, with the understanding that the following day LD will repay the funds (plus a premium) to RP and the securities will be transferred back to LD.[14]

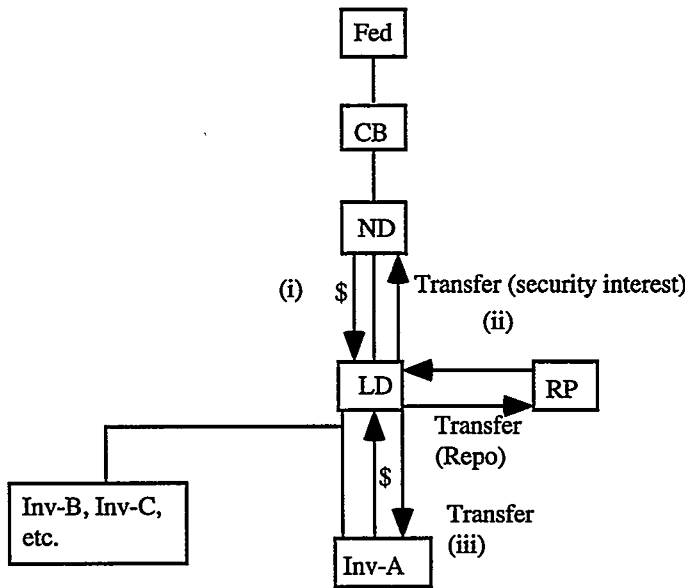
(iii) LD credits, on LD's books, the account of Individual Investor A (Inv-A) with Treasury securities maintained by LD in its inventory (on the books of ND); Inv-A pays LD for the Treasury securities. LD also has other customers (Inv-B, Inv-C, etc.) who have claims to Treasury securities that LD controls.

These transactions and the relationships described in the Treasury Department's example are reflected in the following diagram:

12. March Proposed TRADES Regulations, *supra* note 2, 51 Fed. Reg. at 8846.

13. For a description of the market for United States Treasury securities, see GAO, U.S. TREASURY SECURITIES, THE MARKET'S STRUCTURE, RISKS, AND REGULATION (1986). The United States government securities market is, no doubt, the largest and most significant securities market in the world.

14. Repos are an important means of financing for government securities dealers. *See generally* MARCIA STIGUM, THE REPO AND REVERSE MARKETS 25-26, 57 (1989). In a repo transaction, a seller of a security—such as a funds borrower—sells the security to a buyer—a funds lender. The seller agrees to repurchase the security at a specified price, and the securities buyer agrees to resell the security back to the seller.



This example assumes that each transaction involves the same issue of Treasury securities—for example, Treasury Notes due XX, 199X.

III. Operation of the Good Faith Transferee Priority Rule

Section 357.14 of the 1992 Proposed Regulations provides special priority rules applicable to a "good faith transferee"[15] of a Treasury security. Subsection (b) of section 357.14 provides the principal operative rule: "Except as otherwise provided in §§ 357.15 and 357.19,[[16]] a good faith transferee, in addition to acquiring rights in a security in accordance with section 357.11, acquires its interest in the security free of any adverse claim which arose prior to the transfer of such interest to such transferee."[17] This rule embodies the "last-in-time-first-in-right" principle: Later-in-time transferees cut off the rights of earlier-in-time claimants.

15. The 1992 Proposed Regulations define "good faith transferee" as a "transferee who takes a security or a limited interest in a security for value, in good faith, and without notice of any adverse claim, and to whom an appropriate entry of transfer is made under § 357.12(a)." Prop. Treas. Reg. § 357.14(a), 57 Fed. Reg. 12,265.

16. The 1992 Proposed Regulation § 357.15 provides a special priority for a "clearing lien," which § 357.3 defines as "a security interest granted to a clearing bank or Federal Reserve Bank, pursuant to a written agreement, to secure credit extended in providing clearing services." Prop. Treas. Reg. § 357.3, 57 Fed. Reg. 12,262. Section 357.19 of the 1992 Proposed Regulations provides special rules concerning the rights and duties of the United States and Federal Reserve Banks. Prop. Treas. Reg. § 357.19, 57 Fed. Reg. 12,266.

17. Prop. Treas. Reg. § 357.14(b), 57 Fed. Reg. 12,265.

The last-in-time principle is familiar to the law of negotiable instruments and investment securities: Both a "holder in due course"[18] of an instrument and a "bona fide purchaser"[19] of a security defeat earlier-in-time competing claims.[20] But the rights of a good faith transferee under the 1992 Proposed Regulations would differ in one very significant respect from those of either a holder in due course of an instrument or a bona fide purchaser of a security. Because a holder in due course and a bona fide purchaser normally must take possession of the instrument or security concerned,[21] they not only cut off earlier-in-time claims but they also are positioned—by controlling the piece of paper—to prevent any subsequent purchaser from cutting off their rights. Under the 1992 Proposed Regulations, however, a good faith transferee of Treasury securities would not occupy a similar position; the transferee's book-entry custodian would retain the power to transfer the Treasury securities to a subsequent good faith transferee and thereby cut off the earlier-in-time transferee's rights. At first blush, this aspect of the proposed good faith transferee rule seems sufficient to damn the rule as largely illusory. However, the following analysis of the priority contests raised by the three transactions in the example described in part II demonstrates that the rule is illusory for other reasons as well.

Assume that transactions (i), (ii) and (iii) have taken place in the temporal order listed and that the 1992 Proposed Regulations are in effect. Assume further that LD executed a security agreement in favor of ND covering the Treasury securities in connection with transaction (i). It follows that LD effected the transfer of a security interest in the Treasury securities to ND pursuant to section 357.12(a)(5) of the 1992 Proposed Regulations.[22] From the facts given, there is no reason to doubt that ND qualified as a good faith transferee. LD then transferred Treas-

18. U.C.C. § 3-302(a) (1990) (defining "holder in due course").

19. *Id.* § 8-302(1) (defining "bona fide purchaser").

20. *Id.* §§ 3-306 (holder in due course takes free of certain claims), 8-302(3) (bona fide purchaser acquires interest free of adverse claims).

21. *See id.* §§ 1-201(20) (defining "holder"), 3-302(1) (defining "holder in due course" to mean "holder" under specified circumstances), 8-302(1)(a) (defining "bona fide purchaser" as one "who takes delivery of a certificated security").

22. *See* Prop. Treas. Reg. § 357.12(a)(5), 57 Fed. Reg. 12,264. The 1992 Proposed Regulation § 357.12(a)(5) provides in part:

> (a) Transfer of a security or a limited interest (including a security interest) in a security to a transferee occurs only:
>
> . . . .
>
> (5) With respect to the transfer of a security interest where the secured party is the Federal Reserve Bank or book-entry custodian on whose books the interest of the transferor of the security interest appears, when both
>
> (i) the security has been transferred to the transferor of the security interest in accordance with this section, and (ii) the transferor has executed a written security

ury securities to RP, in transaction (ii), by making an entry on LD's books pursuant to section 357.12(a)(3).[23] As was the case with ND, RP appears to be a good faith transferee. In transaction (iii), LD next transferred Treasury securities to Inv-A by means of a book entry, again under section 357.12(a)(3). Inv-A also appears to be a good faith transferee.

If LD had available sufficient Treasury securities of the issue transferred to ND, RP and Inv-A, it would not matter whether any of those transferees achieved good faith transferee status. If, on the other hand, LD does not have an interest in a sufficient quantity of Treasury securities to satisfy all three claims, one might think that the priority contests would be resolved by the good faith transferee priority rule. For example, the later-in-time transfer to RP would seem to cut off ND's interest (unless ND's security interest qualified for "clearing lien" priority[24]) to the extent necessary to satisfy RP's claim. Similarly, the still-later-in-time transfer to Inv-A would seem to cut off both ND's and RP's claims to the extent necessary to satisfy Inv-A's claim. But this is *not* how the good faith transferee priority rule would work.

Section 357.14(d) provides, in pertinent part:

> agreement with the Federal Reserve Bank or book-entry custodian granting the Federal Reserve Bank or book-entry custodian such security interest.

Id.

23. *See* Prop. Treas. Reg. § 357.12(a)(3), 57 Fed. Reg. 12,264. The 1992 Proposed Regulation § 357.12(a)(3) provides in part:

> (a) Transfer of a security or a limited interest (including a security interest) in a security to a transferee occurs only:
>
> . . . .
>
> (3) At the time an entry is made on the books of a book-entry custodian that credits such security to a securities account maintained for the transferee or that otherwise permits identification of the transferee and the security transferred . . . .

Id.

Arguably, if LD did not itself have available sufficient securities of the issue putatively transferred to RP (perhaps because the securities already had been transferred to ND), no transfer whatsoever was made to RP. *See* Prop. Treas. Reg. § 357.12, 57 Fed. Reg. 12,253 (Treasury Response).

> [T]he Department's view is that although the regulations recognize that in some situations there could be a shortfall of securities in a book-entry custodian's account, (e.g., § 357.14), the ability of a book-entry custodian to effect a transfer under these regulations nevertheless inherently presumes the existence of securities in the account. Such a presumption need not be set out specifically as a provision of the rules.

Id.

Of course, RP would have no way of accurately ascertaining whether LD had sufficient securities to effect the transfer. The remaining discussion gives RP (and Inv-A) the benefit of the doubt and assumes that effective transfers were made to RP and Inv-A.

24. *See* Prop. Treas. Reg. § 357.15, 57 Fed. Reg. 12,265. A "clearing lien" has priority over all other claims of third parties except those of the United States and, in some cases, those of the Federal Reserve Bank. *Id.*

> Notwithstanding paragraph (b) of this section, in the event that the claims to securities of the same issue of those who qualify as good faith transferees exceed the aggregate amount of such securities available to satisfy their claims, the good faith transferees shall share ratably in the available securities of that issue.[25]

Applying this ratable sharing rule to the transactions in the example, and assuming a shortfall in Treasury securities of the issue claimed by RP and Inv-A,[26] those claimants would share the Treasury securities of that issue ratably (for example, pro rata).

The foregoing discussion demonstrates that if there are available sufficient Treasury securities of the issue claimed by transferees—here, RP and Inv-A—whose claims are represented by book entries on the books of the same book-entry custodian, all claims to Treasury securities of that issue will be satisfied regardless of whether all of the transferees—or any of them—achieve good faith transferee status. On the other hand, if there is an insufficient quantity of Treasury securities on that issue, then the good faith transferee rule does not apply as among those transferees; the Treasury securities are shared ratably.[27]

When, if ever, would the good faith transferee rule make any difference? Assuming RP and Inv-A were good faith transferees, each may have obtained rights to Treasury securities that are senior to those of ND.[28] But this conclusion also turns on whether RP and Inv-A could *trace* the Treasury securities they claim to the securities claimed by ND—for example, whether RP or Inv-A could determine if the Treasury securities (or a portion thereof) they purchased were the "same" securities earlier transferred to ND. According to the Treasury Department, however, such tracing is impossible.[29] It follows that the good faith transferee rule would have no impact on the ND versus RP and Inv-A

25. Prop. Treas. Reg. § 357.14(d), 57 Fed. Reg. 12,265.

26. One might read the quoted portion of § 357.14(d) as being applicable to the interest transferred to ND. However, it is clear from the context and the first sentence of that subsection that the quoted portion applies only to claimants who rely on book entries made by the same book-entry custodian (here, LD)—so-called "same-tier" claimants.

27. Prop. Treas. Reg. § 357.14(d), 57 Fed. Reg. 12,265. I can think of only two possible circumstances: Either there are sufficient securities to satisfy the claims of all transferees or there are not sufficient securities to satisfy those claims.

28. Both RP and Inv-A received transfers after the transfer was made to ND. Under the good faith transferee priority rule, the transfers to RP and Inv-A would appear to cut off ND's earlier-in-time interest. *See* Prop. Treas. Reg. § 357.14(b), 57 Fed. Reg. 12,265. For the text of § 357.14(b), see *supra* text accompanying notes 16-17. Under the recent drafts of revised Article 8, ND's security interest would not be junior to the claims of RP and Inv-A, and ND would not be liable to either of those claimants, in conversion or otherwise. *See* U.C.C. §§ 8-510 to -512 (Draft Jan. 4, 1993).

29. *See* November Proposed TRADES Regulations, *supra* note 3, 51 Fed. Reg. at 43,035.

priority contest. Even if tracing were possible, it is the Treasury Department's view that allowing RP and Inv-A to assert their claims against ND would constitute bad policy.[30]

The foregoing discussion illustrates four principal results that might flow from the good faith transferee priority rule.[31] The rule: (1) is irrelevant, because there are sufficient Treasury securities to satisfy all claims; (2) does not apply, because it is superseded by the ratable sharing rule; (3) cannot be applied, because tracing is impossible; or (4) can be applied through tracing, a result reflecting bad policy. These results make one wonder why the Treasury Department chose to cling to the good faith transferee priority rule.[32] It is unfortunate that busy professionals must use valuable time to review and comment on the 1992 Proposed Regulations when that time might be more usefully spent revising Article 8. Fortunately, no one seriously can believe that anything resembling the 1992 Proposed Regulations will become final.

IV. Conclusion

The 1992 Proposed Regulations are the Treasury Department's third attempt since 1986 to come up with workable regulations for book-entry Treasury securities. None of the proposals were workable. That

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> In effect, the [good faith transferee] rule eliminates the possibility of tracing securities beyond what one's book-entry custodian itself maintains. The Department considers this to be an appropriate result given that book-entry securities of the same issue are fungible and generally not subject to tracing.

Id. I have described the quoted passage as "a puzzling non sequitur." Mooney, *supra* note 4, at 372 n.237. "Were the Department of Treasury really satisfied that book-entry Treasury securities could not be traced, then there would be no need for the clearing lien priority rule—lower-tier claimants could never establish that a clearing bank's security interest covered 'their' securities." *Id.*

30. *See* 57 Fed. Reg. 12,255 (Treasury Response to proposed § 357.14).

> As a general matter, such tracing of securities by various claimants appears to be an undesirable phenomenon for the commercial book-entry system in that it treats fungible securities that are transferred quickly and electronically in a way that does not conform to reality. In the extreme, the widespread tracing of particular securities could impair the liquidity of the Treasury securities market.

Id.

31. There is yet another, less significant, priority contest in which a good faith transferee would be senior. *See* Prop. Treas. Reg. § 357.14(d), 57 Fed. Reg. 12,265 ("Among transferees whose interests in securities have been entered on the books of the same book-entry custodian, the interests of the good faith transferees shall have priority over the interests of those who do not qualify as good faith transferees.").

32. The Treasury Department explained that the 1992 Proposed Regulations represent its "most recent thinking." 57 Fed. Reg. 12,245. For the text of the rule, see *supra* text accompanying notes 16-17. Although that suggests disagreement with the recent drafts of revised Article 8, *see supra* note 28, it is my impression that the Treasury Department takes a more favorable view of the revised Article 8 approach.

should not be surprising. The process is fundamentally flawed. At a minimum, drafting complex statutes or regulations requires the give-and-take and careful deliberation of a diverse drafting group that meets over a substantial period of time. This is the approach taken for the uniform state law projects. On the other hand, the approach taken by the Treasury Department—publication of proposed regulations (for the most part, prepared "behind closed doors"), obtaining comments from the public and republishing revised proposed regulations (also prepared largely behind closed doors)—seems much less likely to produce a good product.[33] Although new book-entry Treasury regulations are needed, the Treasury Department should delay final regulations until the Article 8 revision process is complete.[34] New regulations then could be patterned on the best and most current thinking, as reflected by the revised Article 8.

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33. Perhaps it would be plausible for the Treasury Department to hold public hearings to consider drafts and to structure the format of those public hearings substantially along the lines of a deliberative drafting committee meeting.

34. There is reason to believe the Treasury Department will delay the new regulations. At the January 31, 1993 meeting of the Article 8 drafting committee, Treasury Department staff announced that they expect the comment period on the 1992 Proposed Regulations to extend beyond the August 1993 second reading of revised Article 8 before the NCCUSL membership.