

How The Indirect Holding System Affects Investor Suits

Law360, New York (September 29, 2015, 5:51 PM ET) --

In the Tom Clancy thriller "Debt of Honor," foreign agents nearly bring the American economy to its knees by wiping out computer records at a single company — The Depository Trust Co., more commonly known as DTC.[1] It is a fictional plot contrivance, to be sure, but like much fiction, it contains a grain of truth. DTC does indeed exist and plays a crucial role in the securities industry. As the legal titleholder of trillions of dollars of securities, both stock and debt, DTC's computer records are the first link in what is often a long chain of intermediaries existing between the issuer of a security and the ultimate investor in that security. Under most circumstances, this "indirect holding system" operates entirely outside the perception of actual investors who seek to buy and sell securities. Accordingly, many investors wrongly — but harmlessly — consider themselves to have legal title to the securities they believe themselves to have purchased. In litigation, however, fine distinctions matter, and prudent lawyers should be aware of the indirect holding system and consider ways in which its nuances may affect their cases, particularly with respect to issues of standing.



Thomas G. Ward

The Indirect Holding System

Historical Background

Traditionally, legal title to a security (whether a stock or bond) was evidenced by a physical document referred to as a certificate. Such certificates come in two flavors — bearer and registered. A "bearer" certificate is completely negotiable. Merely possessing a bearer certificate is sufficient to entitle the bearer to all rights (such as voting or payment) associated with that security, and the only act necessary to transfer those rights from one person to another is delivery of the certificate.[2]

It is far more common, however, for certificates to be issued in "registered" form, meaning that the issuer of the security maintains a register of security owners, and a transfer of ownership can only be accomplished by updating and amending the register to reflect the transferee as the new owner.[3] To settle the transfer of a registered security, a transferor would typically endorse the securities certificate and surrender that endorsed certificate to the registrar, which would then record the transfer of the associated security to the new owner.[4]

In the mid-20th century, as the volume of securities transactions taking place in the United States increased at an ever-growing pace, this labor-intensive process for settling securities transactions began to prove burdensome. By the late 1960s, the strain reached a breaking point, commonly referred to as

the “paper crunch.” Brokerage firms found themselves increasingly unable to settle securities transactions in a timely manner, resulting in unfulfilled deliveries. For a period of approximately six months in 1968, the New York Stock Exchange took the extraordinary step of reducing trading from five days a week to four in order to give the beleaguered brokerage firms additional time to process a backlog in settlements that at one point exceeded \$4 billion in value. More than 100 brokerage firms failed in part due to defaults on outstanding delivery obligations.[5]

In response to the “paper crunch” crisis, the United States transitioned to an “indirect holding system” model in the 1970s. In an indirect holding system, legal title to securities is held by a single, centralized depository, and the registered certificates for those securities are physically stored in the depository’s vaults.[6] Trade in the securities themselves ceases, thus avoiding any need for delivery, endorsement, amendments to the register, or the like. Instead, what investors trade are beneficial interests in those securities — referred to as “securities entitlements” by Article 8 of the Uniform Commercial Code.[7] These beneficial interests are recorded, in the first instance, as “book entries” on the accounts of the depository institution. Brokerage firms and other entities reflected in those book entries as holding a beneficial interest in the securities may in turn keep their own securities accounts and their own “book entries” identifying yet others as having beneficial interests therein. Ultimately, at the end of this chain will be an investor with an actual economic stake in the security, and a corresponding beneficial interest therein.

The model is thus called an “indirect holding system” because that investor who purchases an economic stake in the security does not own legal title to the security itself, but rather owns a beneficial interest through a series of at least one or more “securities intermediaries,” the last of which will typically be the depository that serves as the registered holder of the security.

By centralizing custody and legal ownership of securities, an indirect holding system “immobilizes” the securities themselves, and only the securities entitlements reflected through the book entries of the depository and its participants are traded on the market. An indirect holding system thus greatly reduces the burden associated with settling securities transactions. But there are other consequences as well, some of which can introduce their own complexities. Issuers of equity or debt securities may reflect the depository as the sole registered holder of the securities in question. When that is the case, the issuer will engage directly with the depository concerning actions that implicate and are dependent upon the rights of the securities holders — such as distributing dividends, paying required principal and interest, giving notices, or taking votes.[8] The payments, notices and proxy voting material disseminate through the chain of book-entry account holders until they arrive in the hands of the ultimate beneficial holders.

DTC and Cede & Co.

In 1973, DTC was formed to serve as the central depository for certain classes of securities traded in the United States. This enabled widespread adoption of the indirect holding system. In 1976, another institution, the National Securities Clearing Corp. was created to address a separate but related issue concerning the settlement of securities transactions — the need to net trades and payments among participants. In 1999, the Depository Trust & Clearing Corp., or DTCC, was created as a holding company to combine DTC and NSCC.

The breadth and scope of DTC’s role in our modern securities system is undeniably impressive. Last year, DTC and its affiliate NSCC settled more than \$1.6 quadrillion in securities transactions, and DTC served as depository for securities with an approximate net market value of almost \$40 trillion. To put it in

context, consider that every two days, DTCC processes the equivalent of the U.S. annual gross domestic product.[9]

Securities deposited with DTC are frequently registered to and thus legally owned by DTC's partnership nominee, Cede & Co. (the name Cede is derived from the words certificate depository).[10] Such securities may be certificated with "jumbo" or "global" certificates, in which case a single physical certificate evidences DTC's legal title to the total fungible bulk of shares or notes associated with that issue of securities (the number of shares or total amount of the obligation so evidenced may fluctuate over time).

Financial institutions such as banks and brokers that are DTC "participants" may deposit securities with DTC, hold direct positions in securities that have been deposited with DTC, and engage in direct trades regarding those positions with other DTC participants. DTC maintains computerized records reflecting the book-entry positions held by DTC participants and changes to those positions. Transactions are settled by debiting book-entry interests from the selling participant's account on DTC's records and crediting those interests to the buying participant's account, while simultaneously debiting funds from the buying participant's account and crediting the selling participant's account. If the DTC participant is holding a position for others rather than for itself, that fact is not reflected on the DTC's records, but rather on a separate computerized record of book entries maintained by that DTC participant.

Implications for Attorneys

At the core of the indirect holding system is a separation of legal and equitable ownership. DTC's partnership nominee, Cede & Co., holds legal title with respect to the securities that are registered to it, but does not hold equitable title. Equitable title is held by investors, who trace their claim to that beneficial interest through a series of securities intermediaries.

This dichotomy is of limited significance in the context of actions under the federal securities laws. Claims for securities fraud under Section 10(b) of the Exchange Act and SEC Rule 10b-5 for example, may only be brought by one who purchases or sells a security.[11] Scant attention has been paid by courts to how that requirement maps against the relationships that exist among the many layers of participants within the indirect holding system. But securities fraud cases are brought every day by pension funds, individual investors and other beneficial holders of stock with little regard to who the record holders may be. Indeed, at least one court has observed that in the context of a securities class action settlement, plaintiffs' counsel must depend to some degree on securities intermediaries in the indirect holding system — including DTC and its participants — even to identify and forward notice to the beneficial owners who constitute the actual members of the class.[12]

Yet as another court has noted, it is not necessarily appropriate to require the securities intermediaries to themselves fund the costs associated with identifying and giving notice concerning a proposed settlement to the beneficial holders who comprise the class because the securities intermediaries are often not "parties" to the action.[13] There are cases that split hairs as to whether an asset manager (who will typically hold most of the managed securities "in street name," i.e. for the benefit of another, yet also may have discretion to make investment decisions) qualifies as a "purchaser" for purposes of standing to sue under the Exchange Act.[14] But courts do not preclude beneficial holders of stock from bringing securities fraud actions in their own name on the premise that only registered holders have standing to bring such actions. The statutory and regulatory framework that governs securities fraud actions simply does not compel such an outcome.

Contracts, however, are a different matter. Debt securities are typically structured through a set of related contracts that carefully define the roles and responsibilities of the issuer and others, including third parties that serve as corporate trustees. Many such contracts contain provisions and definitions that effectively limit standing to the holders of record, which in most cases will be Cede & Co. Specifically, such contracts will frequently confer various rights to the “noteholder” or “bondholder,” and then explicitly define that term as referring to the registered holder of a global certificate — i.e., Cede & Co. Courts give rigid application to such provisions. Last year, for example, a New York state court dismissed an action by a beneficial holder for payment on defaulted notes, holding that “it is well settled that a beneficial holder of a note lacks standing to sue for payments due upon the note where, as here, the indenture reserves the right to sue to the registered holder of the note.”[15] Similarly, New York state courts have held that beneficial holders are unable to sue for breach of the indenture or related contracts to the extent those contracts confer standing only upon registered holders.[16]

A relatively straightforward method exists by which beneficial holders may obtain standing to sue on such contracts — the beneficial holders may obtain an assignment of rights from the registered holder. Both state and federal courts in New York have acknowledged that if such an assignment is made by the proper party (i.e., Cede & Co.) then the beneficial owner’s lack of standing is cured.[17]

But there are potential pitfalls to such assignments. First there is the matter of timing. While the Second Circuit has permitted beneficial holders to cure their lack of standing by obtaining assignments from a registered holder even after a lawsuit has commenced, some New York state courts have been less forgiving.[18] Similarly, defendants that fail to recognize and assert a standing defense early in an action may potentially be held to have waived it.[19]

Second, there is the possibility that if an investor depends upon an assignment to obtain standing, substantive issues in the case may come out differently than they would if the investor had standing to sue in his or her own right. Courts commonly observe that an assignee “stands in the shoes” of an assignor and thus acquires no greater rights than its assignor.[20] Accordingly, an assignee is typically subject to any defenses that could be asserted against the assignor. The implications of this have not been well explored in the case law, and may present litigators who are sensitive to such considerations with novel arguments. Simply by way of example, it is possible that a registered shareholder (i.e., Cede & Co.) that has held such status since a security was first issued may be subject to different dates for purposes of calculating a statute of limitations defense than would an investor who has more recently acquired a beneficial interest in a security.

Attorneys who litigate securities actions would thus be wise to keep in mind the nature of the indirect holding system and to carefully evaluate early in any litigation the consequences it may have for particular claims. Counsel for plaintiffs who determine that Cede & Co. has standing to bring a particular claim may want to ensure that they build in time to pursue an assignment before litigation commences. Plaintiffs counsel may also wish to evaluate whether there are alternate mechanisms by which to obtain standing — for example, it may be possible for an investor to obtain “definitive notes” through which the beneficial holder becomes the registered holder as well with respect to a given investment. Counsel for defendants must quickly assess new actions to evaluate whether the named plaintiffs have standing and, if they lack standing, must carefully consider the most advantageous way to present that defense. And counsel for all parties should be alert for ways in which substantive issues might take unexpected twists and turns if standing is premised on an assignment.

By paying attention to the details of how the DTC operates, Tom Clancy’s protagonist in “Debt of Honor,” the heroic Jack Ryan, is ultimately able not only to save the United States from economic ruin,

but also to turn his foes' attack on the DTC's computer records to his own advantage. Commercial litigation may not always be as thrilling, but attorneys who pay attention to how the indirect holding system operates may find themselves similarly able to work dramatic and favorable changes in the plotlines of their cases.

—By Thomas G. Ward and Daniel M. Dockery, Williams & Connolly LLP

Thomas Ward is a partner with Williams & Connolly in Washington, D.C., and co-head of the firm's bankruptcy litigation group. His practice focuses on financial and securities litigation and bankruptcy litigation.

Daniel Dockery, also based in Washington, is counsel with Williams & Connolly. His practice focuses on financial and securities litigation and health care litigation.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Tom Clancy, *Debt of Honor* (1994).

[2] See U.C.C. § 8-102(2) (defining “bearer form”).

[3] See U.C.C. § 8-102(13) (defining “registered form”).

[4] See, e.g., U.C.C. §§ 8-301, 8-304, 8-401.

[5] See New York Stock Exchange, “Crisis in the Securities Industry — A Chronology: 1967-70” (July 30, 1971), available at http://www.sechistorical.org/collection/papers/1970/1971_0730_NYSECrisis.pdf

[6] For a more detailed account of the development of the indirect holding system, see David C. Donald, “The Rise and Effects of the Indirect Holding System: How Corporate America Ceded Its Shareholders to Intermediaries,” (Sept. 2007), available at http://publikationen.uni-frankfurt.de/volltexte/2007/4885/pdf/ILF_WP_068.pdf.

[7] See UCC, Article 8, Part 5 (“Securities Entitlements”).

[8] A description of services offered by DTC in this regard is available at <http://www.dtcc.com/asset-services/issuer-services/proxy-services.aspx> and <http://www.dtcc.com/asset-services/corporate-actions-processing.aspx>.

[9] See DTCC, “Securing Today, Shaping Tomorrow: Our Capabilities” (2014), available at http://www.dtcc.com/~media/Files/Downloads/About/DTCC_Capabilities.pdf.

[10] Increasingly, securities are being issued in uncertificated form, in which case Cede & Co. need not serve as registered holder. Via the Direct Registration System (“DRS”) and other mechanisms, market participants may become registered holders of securities traded via the computer systems of DTCC. However, in many cases the holder in whose name a security is registered will be a securities broker that is holding “in street name” for the benefit of a client investor. In those circumstances, the investor still is “indirectly holding” the security, and holds a security entitlement rather than the security itself.

[11] See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

[12] *Mashburn v. Nat'l Healthcare Inc.*, 684 F. Supp. 660, 66-67 (M.D. Ala. 1988).

[13] *In re Penn Central Sec. Litig.*, 560 F.2d 1138 (3d Cir. 1977) (“The plaintiff class representatives urge, however, that the Brokerage Houses should, in this case, be treated as parties, since as street name record owners they were theoretically members of the plaintiff class. Entirely aside from the fact that the court order for notice to the beneficial owners in effect put the street name record owners outside the class and substituted the beneficial owners, we think that such a construction of the term “party” in Rule 34 would be strained.”).

[14] Compare, e.g., *In re Sonus Networks Sec. Litig.*, 247 F.R.D. 244, 250-51 (D. Mass. 2007) (holding that asset manager that was attorney-in-fact for its clients with unrestricted decision-making authority qualified as “purchaser”) with *In re Cardinal Health Inc. Sec. Litig.*, 226 F.R.D. 298, 311 (S.D. Ohio 2005) (concluding an advisor does not qualify as a purchaser). See also Brian P. Murray, *Does An Asset Manager Have Standing Under the Federal Securities Laws?*, 79 *St. John’s L. Rev.* 405 (2005).

[15] *Cortlandt St. Recovery Corp. v. Hellas Telecommunications S.a.r.l.*, 996 N.Y.S.2d 476, 489 (Sup. Ct. 2014); see also *Springwell Navigation Corp. v. Sanluis Corporacion SA*, 849 N.Y.S.2d 34, 34 (App. Div. 2007).

[16] See *MacKay Shields LLC v. Sea Containers Ltd.*, 751 N.Y.S.2d 485, 486 (App Div. 2002).

[17] *Springwell Navigation Corp. v. Sanluis Corporacion SA*, 917 N.Y.S.2d 560, 561 (App. Div. 2011); *Allan Applestein Trustee F/B/O D.C.A. Grantor Trust v. Province of Buenos Aires*, 415 F.3d 242 (2d Cir. 2005).

[18] Compare *Allan Applestein*, 415 F.3d 242 (2d Cir. 2005) (assignment after commencement of suit may cure standing) with *Repsol SA v. The Bank of New York Mellon*, 2014 WL 468910 (N.Y. Sup. Feb. 4, 2014) (dismissing breach of contract claim pursued by beneficial holder, and holding that efforts to cure the standing deficiency after suit had already been brought could not salvage the claim).

[19] *Cortlandt St. Recovery Corp.*, 996 N.Y.S.2d at 486 (observing that “[t]he Court of Appeals has held unequivocally, albeit without elaboration, that a ‘challenge to [a party's] standing was waived because it was not raised as an affirmative defense, or by way of motion to dismiss.’”).

[20] *Cortlandt St. Recovery Corp.*, 996 N.Y.S.2d at 489.
