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Can Prudential Regulation Be Achieved by Means of Technology? Lessons from US Electronic Chattel Paper

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US UCC Article 9 Control of Electronic Chattel Paper

- Abstract, paper and virtual administration of property rights
- US automobile dealer financing
- Centralized versus decentralized prudential regulation
- Article 9 “control” in lieu of “possession” provisions

How to administer ownership of property?



Yap Island Stone Money: oral transfers in public ceremony

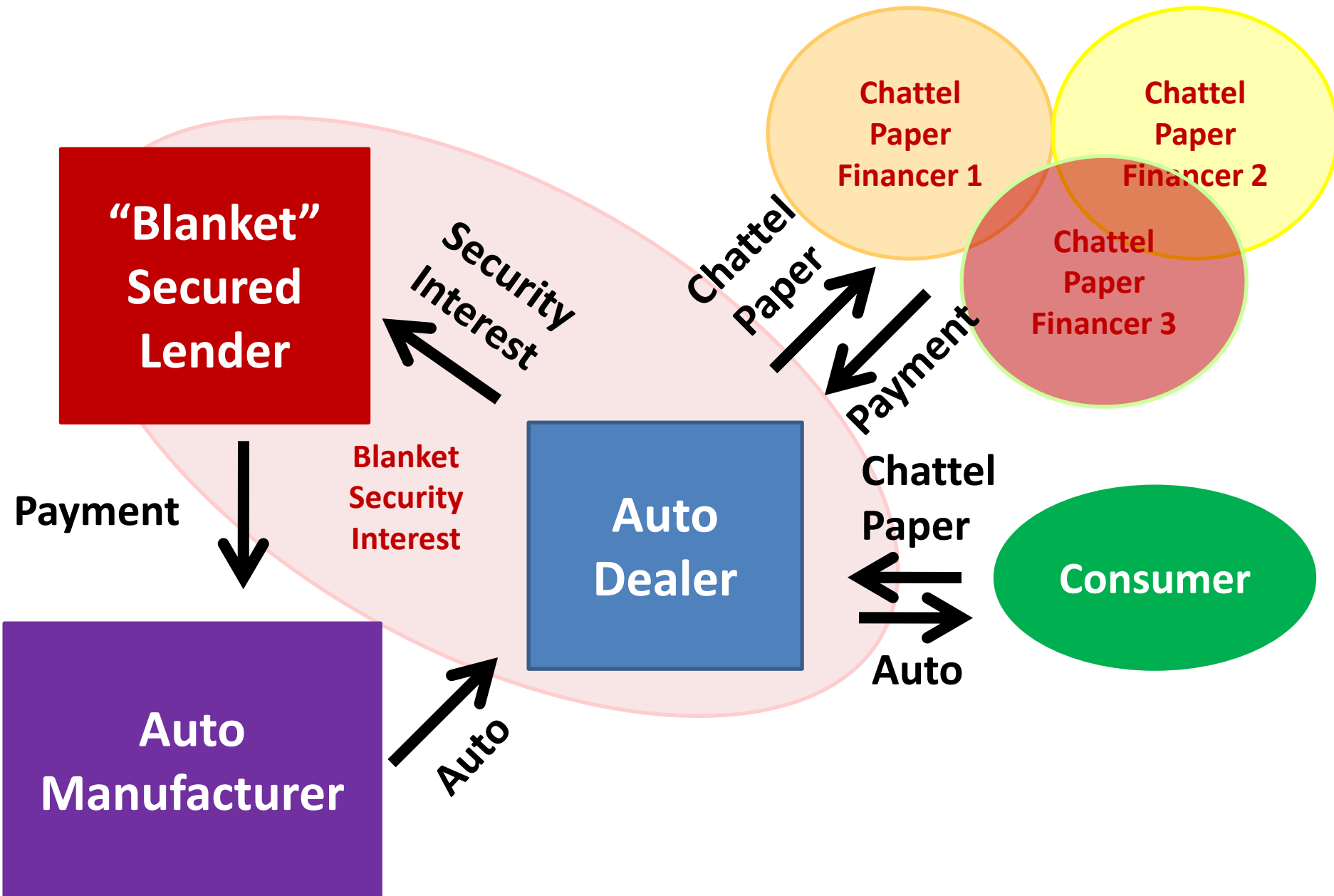
Abstract, paper, recorded and virtual administration of property rights

- Physical possession
- Abstract property right: oral transfers are not fixed in writing, insecure if memory fails
 - Yap stone money, feudal rights in land
- Abstract property right written by a transacting party on paper: only as trustworthy as the party maintaining the records
 - Accounts receivable
- Abstract right written on a piece of paper that uniquely “embodies” property right
 - Negotiable instrument, document
- Abstract right recorded in central recording system under the control of a trusted third party
 - Land records, secured lending recording systems
- Abstract right written by a transacting party in its own computer records: only as trustworthy as the party maintaining the records
 - Treasury bills, deposit accounts, mutual funds, company shares
- Abstract right written in a highly secure computer record designed to mimic the administrative functions of paper negotiable instruments in a highly reliable manner
 - Electronic chattel paper, electronic transferable record

What is “Chattel Paper”?

- Two sources of finance for American auto dealers
 - “Floor planning” from bank for inventory, working capital
 - Sell cars for consumer notes, discount notes to “chattel paper” financiers
- Auto dealers objected to floor plan financier priority over chattel paper financier under 1957 UCC Article 9 “Blanket Security Interest”
 - Exception: chattel paper financier who takes possession has priority
 - Exception does *NOT* require compliance with UCC Article 3 negotiability for note
- If cost of migration from paper to electronic note includes loss of priority for purchaser, then cost is too high

US Automobile Dealer Financing



Prudential Regulation of Financial Markets

- Define Prudential Regulation
 - National government restrictions of business models of financial intermediaries to insure orderly competition and prevent contagion from financial markets to general commerce
 - Examples: licensed depository institutions, insurance companies
- Financial markets outside scope of direct prudential regulation
 - Working capital finance: accounts receivable financing, factoring, leasing
 - Securities markets
 - Other?
- Negotiable Instruments versus Prudential Regulation
 - Decentralized administration of risk management at point of “negotiation”
 - Decentralized enforcement through litigation

2001 Revised Article 9 Treatment of Electronic Assets

- New recognition of security interest in bank deposit account, electronic letter of credit
 - Confirmation that bank recognizes security interest is enough to establish “control”
 - Article 9 leverages prudential regulation of banks to insure credibility of security interest
- New recognition of security interest in electronic chattel paper
 - But no prudential regulation of “chattel paper” financiers
 - “Control” requires high level of technological sophistication that can mimic functional attributes of physical possession

What is Electronic Chattel Paper (2011)?

- [General rule: control of electronic chattel paper.] A secured party has control of electronic chattel paper if a system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned.
- [Specific facts giving control.] A system satisfies subsection (a), and a secured party has control of electronic chattel paper, if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:
 - a single authoritative copy of the record or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;
 - the authoritative copy identifies the secured party as the assignee of the record or records;
 - the authoritative copy is communicated to and maintained by the secured party or its designated custodian;
 - copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the participation of the secured party;
 - each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
 - any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision

Adoption of ECP?

- 2001 Revised Article 9 became effective
- 2005 Nissan securitized ECP for the first time
 - 2010 more than half of Nissan CP = ECP
- 2001-2008 Industry standard setting, different pilots
- 2008-2009 Auto industry recession
- 2010 volume of ECP slowly growing again