MISINFORMATION IN THE STATE LEGISLATURES: THE BASELESS ATTACK ON UCC ARTICLE 8

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OVERVIEW: PROPOSALS TO AMEND UCC ARTICLE 8

Proponents' statements:

- Include broad attacks on much of UCC Article 8 as a whole, and in particular Part 5 of Article 8
- Assert that under Article 8 customers will lose property rights and will suffer serious losses in the event of a collapse of significant securities intermediaries
- Assert that the existing infrastructure and regulatory guardrails are wholly inadequate to protect investors

OVERVIEW: THE PROPOSED AMENDMENTS "FIX" A NON-EXISTENT "PROBLEM"

- UCC Article 8 and other laws provide carefully constructed rules that protect customers in the event of a securities intermediary insolvency case
- Customers' property rights are not affected without their consent under Article 8
- Securities intermediaries must hold customer securities in a "segregated account" if the customer has not consented to the intermediary creating a security interest in those securities

PROPOSED AMENDMENTS TO UCC

- Proponents: David Rogers Webb (author of *The Great Taking*) and Don Grande (North Dakota lawyer)--with support from the Heartland Institute
- Introduced in a few states in early 2024 and planning introductions in several states in 2025, including ND, SD, TN, NH, OK, IA, UT, TX, and AR.

WEBB'S UNDERLYING THEORY

- **Premise of *The Great Taking*:** A financial collapse is coming and the UCC is a tool that will allow the largest financial institutions to take financial assets of investors on a massive scale, leaving millions of investors destitute--a classic "conspiracy theory"

WEBB'S UNDERLYING THEORY

E.g., recent Webb response to interview question "When will the wheels come off?":

"We are in it now. The wheels will not come off because they have to come off. [The wheels] . . . will come off when they choose to make it happen. There does not have to be a financial collapse, they have engineered this. They will make it happen when they choose to make it happen." . . . There will be something absolutely shocking that will terrify everyone and we are already well into this global hybrid war. Already people have been killed that rivals the world wars. The same program goes forward regardless of who is President of US. The only way to change things is thru direct personal agency done at the local level."

PROPOSED AMENDMENTS TO UCC 8-511

Deletion of priority rules:

- 8-511(b) (secured creditor of securities intermediary has priority in financial asset over claims of entitlement holders to the financial asset *IF* the secured creditor has control)
- 8-511(c) (secured creditor of clearing corporation securities intermediary has priority in financial asset over claims of entitlement holders to the financial asset).
- General rule of 8-511(a) would then apply (entitlement holder priority).

Amendments on applicable law: Some bills propose amendments, not all the same, to Articles 8 and 9 on applicable law. It is not clear what will ultimately be proposed, but all proposals so far are problematic.

SOUND POLICY BASIS FOR CURRENT LAW

- These priorities (under Article 8 or insolvency laws) are necessary for secured credit extensions to securities intermediaries.
- 8-511 is an important part of a balanced set of rules for indirect holding system in Article 8.
- The *primary* focus here is on *factually incorrect claims* concerning law and market practice by proponents of amendments--not on defense of current law.

INCORRECT CLAIMS SUPPORTING PROPOSED AMENDMENTS

- Proponents are making and relying on factually incorrect claims.
- The following slides illustrate some examples of these incorrect claims.
- TO BE CLEAR: There is always room for policy disagreements over the substance and operation of any set of legal rules. No legal regime can, or should, claim absolute perfection or immunity from legitimate criticism.
- The incorrect claims identified here, however, are demonstrably incorrect and well outside the bounds of legitimate criticism and debate.

INCORRECT CLAIM 1

- The 1994 amendments [i.e., 8-511(b) and (c)] to "*Article 8 ensure[] that the investor would become an unsecured creditor with the investors' claims to their securities falling at the back of the line in an insolvency proceeding. . . . [I]n the event of a wide scale financial crash, thousands or even millions of investors could lose a significant portion of their assets to secured creditors.*"
- The 1994 *"[c]hanges to Article 8 completely abrogated property rights to investment securities of individuals and gave them to the secured creditors of securities intermediaries"*

INCORRECT CLAIM 1: CORRECTED

- 1994 8-511 actually provides priority rules that are *facially more favorable* to entitlement holders than previous text of Articles 8 and 9.
- For insolvent broker-dealers, secured creditors of debtor have priority over customers/entitlement holders under Securities Investor Protection Act (SIPA) and before that Bankruptcy Code and former Bankruptcy Act. This priority is essential to facilitate credit to broker-dealers that provides funding for margin loans to customers.
- The same priority result could be achieved in the insolvency of a bank securities intermediary.

INCORRECT CLAIM 1: CORRECTED

- Under UCC, former Bankruptcy Act, Bankruptcy Code, SIPA, and bank insolvency laws, because customers have property claims they would be unsecured creditors only if debtor had no unencumbered relevant securities whatsoever.
- 1994 Article 8 amendments preserved and even enhanced, and did not abrogate, property rights of entitlement holders.
- 1994 amendments: (i) new protection from adverse claims for innocent acquirers of security entitlements (8-502), (ii) protections were balanced with limitations on claims of entitlement holders against transferees (including entitlement holders of other securities intermediaries (8-503(d)-(e)).
- Secured credit to a securities intermediary generally would not be available without assurance of first priority and priority over customers/entitlement holders.

INCORRECT CLAIM 2

"[T]here has already been an instance in which the changes to UCC Article 8 were used as the legal basis for the taking of investors' securities. These legal decisions have cemented into law the assertion that large financial institutions have priority over customer assets. When Lehman Brothers filed for bankruptcy during the 08 financial crisis one of its primary lenders was JPMorgan Chase. . . . As a result of the changes to UCC Article 8, as well as a 2005 change to federal bankruptcy law, JPMorgan was able to freeze Lehman's institutional accounts as collateral for the loans that Lehman could no longer pay."

INCORRECT CLAIM 2: CORRECTED

- The proponents' reliance on the decision in the Lehman insolvency proceedings is misleading and inapposite. The UCC 8-511 priorities were not the basis for the decision, which was based on the Bankruptcy Code safe harbor provisions.
- Securities customers (entitlement holders) of the Lehman broker-dealer did not lose any principal on their investments and the accounts of all retail investors were sold to a different broker-dealer without any loss to customers.

INCORRECT CLAIM 3

- "*[O]wnership of securities as property has been replaced with this concept of a security entitlement. This was a newly created invention in the 1994 amendments to the UCC, it had never existed in 400 years of securities law. You're told that this is a property interest, it functions like a contractual claim.*"
- "*[M]argin accounts existed for centuries, people could use their own collateral; having a margin account was not something that was new with the 1994 revisions. So people had property. What has been done is to turn their claim into a contractual claim which is worth nothing in insolvency.*"

INCORRECT CLAIM 3: CORRECTED

- Under 1994 Article 8 an entitlement holder has a proportionate property interest in financial assets held in a securities account as a fungible bulk. These assets are not property of the intermediary and are not subject to claims of the intermediary's general creditors.
- The proportionate property interest rule was applicable under all earlier versions of the UCC, was not new introduced in the 1994 amendments, and was applicable to securities accounts long before the UCC was first published in 1952.
- A security entitlement does not change the rights of a customer "into a contractual claim," actually or functionally, or into "a contract, not a property right." As explained below, a security entitlement is not "*worth nothing in insolvency.*"
- These protections are reinforced by a requirement that securities intermediaries hold customer securities in a "segregated" account not subject to a security interest, unless the customer has consented to the intermediary granting a security interest in those securities.

INCORRECT CLAIM 4

- An entitlement holder's claim "*is worth nothing in insolvency*."

- *"The Securities Investor Protection Corporation has got some potential issues in that it's not funded sufficiently to cover a systemic financial crisis that we've been talking about. It's really designed to handle one failure at a time."*

INCORRECT CLAIM 4: CORRECTED

- In an insolvency proceeding of a securities intermediary other than a broker-dealer (e.g., bank), the property interests of entitlement holders would remain property of the entitlement holders and would not be available for distribution to general creditors of the intermediary.
- In a broker's SIPA liquidation proceeding, all securities (of *all issues*) held by the debtor broker in fungible bulk for its customers make up "customer property," valued as of the petition filing date. Customers share pro-rata in customer property based their respective "net equity"--the value of securities and cash credited to customers' securities accounts (whether or not the securities are then held) less the amount of debt owed to the broker.

INCORRECT CLAIM 5

- *"If you simply reverse this* [by deleting the 8-511(b) and (c) priorities and amending 8-110], *now any investors in the state have priority to their own assets but that put investors in this state structurally ahead of the secured creditors and actually gives a super priority to investors in the State of Oklahoma to all the pooled assets."*
- **[Question from legislator:]** . . . "*So let's say you go back to Lehman Brothers and if we had already amended this, you're telling me that Oklahoma investors would be treated differently because of our law and our state . . .*"
- "*Correct.*"

INCORRECT CLAIM 5: CORRECTED

Had Oklahoma adopted the proposed amendments:

- Oklahoma's adoption of the amendments would *not* give "investors in" Oklahoma a "super priority," even under any of the proponents' proposed changes to the rules on applicable law.
- Oklahoma's proposed amended Article 8 would not apply in any securities intermediary insolvency case unless the court was sitting in a state whose courts would apply Oklahoma law. Without clarity on proposed amendments (if any) on applicable law nothing more can be said now.
- In any event, the proposed amended 8-511 would not apply in a liquidation case of a broker under SIPA (such as the Lehman broker).

INCORRECT CLAIM 5: CORRECTED

- Enactment of the amendments nonetheless could result in considerable mischief and costs by inducing baseless litigation and offering baseless source of leverage for settlements in a securities intermediary's insolvency proceeding.
- For some banks, especially community banks, or for local or regional brokers, a state that has adopted the amendments might be (i) a potential forum for an insolvency proceeding, (ii) the securities intermediary's jurisdiction, or (iii) the location of the intermediary. In these situations, if the proposed amended 8-511 were applicable, secured credit likely would be chilled or eliminated for the intermediary.

INCORRECT CLAIM 5: CORRECTED

- To the extent that a customer's net equity claim exceeds its ratable share of customer property, SIPC will advance funds to the SIPC trustee to pay or satisfy a customer's net equity claim not to exceed $500,000 for each customer (for a claim for cash, not to exceed $250,000.
- There is no basis for proponents' claim that SIPC is underfunded and could not meet demands on its funds in the event of a "systemic financial crisis" or "widespread market failure."

FINAL THOUGHTS

- As several incorrect claims indicate, the proponents' are launching a broad attack on indirect holding under Article 8, far beyond the scope of the proposed amendments.
- They also are seeking to undermine generally the ULC's uniform law process and the integrity and policy balance of the UCC, in particular (e.g., "The ULC and the *banks that they serve* . . ."; "After this was implemented through the UCC in the U.S. in '94, *at the behest of the banking interest* . . .").

FINAL THOUGHTS

- If the proposed amendments gain traction in the legislatures, and if the proponents gather credibility in that process, it will no doubt impede the adoption of the 2022 Amendments to the UCC. Moreover, it may have far-reaching and durable obstacles to necessary continual updates and revisions to the UCC and other uniform laws.