Uniform Law Commission

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

111 N. Wabash Ave.
Suite 1010
Chicago, IL 60602
(312) 450-6600 tel
www.uniformlaws.org

Statement on Ownership of Investment Property under Uniform Commercial Code Article 8

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Executive Summary

Recent legislation introduced in several state legislatures proposed to repeal certain provisions of Article 8 of the Uniform Commercial Code (UCC). Proponents of these bills contend that UCC Article 8 allows a securities intermediary (e.g. a bank or brokerage firm) to assume ownership of its customers' investment property in the event of the intermediary's insolvency. This is false. This statement explains how individual investors are protected in the event of a securities intermediary's insolvency.

The below Q&A offers an overview of UCC Article 8 and its impact on investment securities, followed by an in-depth explanation of the specific provisions at issue with an expanded analysis and examples to illustrate how these provisions benefit investors.

Q&A

What is the UCC?

The UCC is a set of rules enacted in every state that govern a wide variety of commercial transactions in the United States. This set of rules allows commerce to proceed predictably and gives Americans the confidence to do business with each other across state lines, because the law of every state is uniform.

The law governing securities (stocks, bonds, and other types of investments) is a combination of federal and state law. Federal law provides a regulatory framework that governs the issuance and registration of securities offerings and regulates securities firms and exchanges to ensure investors are treated fairly and their investments are kept safe. State law in the form of UCC Article 8 provides the rules that govern certain rights and obligations of parties to securities transactions – including issuers, buyers, sellers, borrowers, lenders and securities custodians. Together, these laws protect the interests of investors and provide additional benefits, like access to credit.

These UCC Article 8 rules, which were approved by the Uniform Law Commission and the American Law Institute in 1994, together with federal laws and Securities and Exchange Commission (SEC) regulations, have protected investor interests for 30 years. They also promote efficiency and reduce the risk of legal disputes over financial transactions.

The ULC is a nonprofit formed in 1892 to create nonpartisan state legislation. Over 350 volunteer commissioners—lawyers, judges, law professors, legislative staff, and others—work together to draft laws ranging from the Uniform Commercial Code to acts on property, trusts and estates, family law, criminal law and other areas where uniformity of state law is desirable.

Why is UCC Article 8 being scrutinized?

Proponents of legislation to amend Article 8 have said that its provisions allow a securities intermediary (e.g., a bank or brokerage firm) to assume ownership of its customers' investment property in the event of the intermediary's insolvency. This is false.

What do critics of UCC Article 8 have wrong?

Most investors today own their securities through a securities account maintained with a securities intermediary (like a broker or bank), rather than holding the securities directly. This indirect holding system provides many advantages for investors, such as quick, computer-based trading and secure backup of their account holdings. Under UCC Article 8, which has been enacted in every U.S. state, an investor who owns securities through an intermediary has a property interest in the securities, not merely a contract claim against the intermediary as the critics contend[1]. Because the securities are not property of the intermediary, they are generally not subject to the claims of the intermediary's creditors. That is, the investors will not lose their assets just because the intermediary becomes insolvent.

Proponents of legislation to amend UCC Article 8 have focused on two narrow exceptions that apply only in special situations; they misunderstand the purpose and effect of those exceptions. The first exception applies when the investor consents in writing to the intermediary pledging the investor's securities. The investor may, for example, borrow funds from the securities intermediary to purchase securities and pledge the securities as collateral to secure payment of the loan. Under these voluntary arrangements, UCC Article 8 gives priority to the securities intermediary's lender who has accepted securities as collateral for an extension of credit to the securities intermediary that enables it to engage in these types of transactions.

The other exception deals with secured creditors of clearing corporations. Clearing corporations are companies that play a central role in the clearing and settlement of most of the securities trades executed daily by investors who hold their securities through brokers and banks. These types of organizations were created decades ago to improve the safety and soundness as well as the efficiency of the securities markets. UCC Article 8 gives priority to those lenders who extend secured credit to the clearing corporation to provide the liquidity that might be needed to settle a given day's trades if one of the brokers or banks fails to perform its obligations to deliver securities sold or make payment for securities purchased. The extension of credit prevents one firm's failure from causing a massive market disruption that would harm all investors.

What would happen if these two exceptions were repealed through state legislation?

The proposed alterations to UCC Article 8 are unnecessary and potentially harmful to investors. If the exceptions were repealed, investors would find that obtaining margin loans would be more expensive or, in some circumstances, these financial services might not be available. It is also possible that the differential treatment would lead to a clearing corporation's inability or unwillingness to permit banks or brokers in a state that has eliminated the relevant exceptions to remain members of that clearing corporation. That elimination would seriously hinder the ability of the bank or broker to conduct business.

[1] See UCC § 8-503 establishing the property interest of entitlement holders.

Repealing these provisions of UCC Article 8 would also significantly impede commerce. Interstate business thrives because the UCC makes transactions predictable. If laws differed between states, companies, investors, and consumers would have to either learn about, plan for, and contract around those differences, or else avoid doing business in states with non-uniform laws. At a minimum, repealing these exceptions would add unnecessary legal expenses to otherwise routine commercial transactions, and in a worst-case scenario could cause some companies to cease doing business in states with non-uniform laws.

Have these exceptions led to losses for individual investors in the past?

No individual investor has *ever* suffered a loss because of UCC Article 8's two limited exceptions to the general rule that gives investors priority over creditors to securities held by their intermediaries. That proved true even after several securities intermediaries, including Lehman Brothers, Inc., failed during the 2008 recession.

In-Depth Analysis

A. The Purpose of the Uniform Commercial Code

The UCC is a set of rules to govern commercial transactions that generally reflect the expectations of participants in commercial markets. Many of the UCC's rules only apply when the parties to a transaction have not made a different agreement. However, some rules represent public policy choices that restrict or prevent parties from deviating from these expectations.

Because these uniform rules have been enacted in every state, commerce in the United States is predictable and Americans generally have confidence to do business with strangers. This is not always the case in other parts of the world and is a major reason why American commercial markets thrive.

B. Background Concepts

The legislation proposed in several states would amend UCC Section 8-511. To explain why that provision should not be changed, it is helpful to understand two concepts underlying much of UCC Article 8: securities accounts, and indirect holding of securities.

1. Securities accounts

A securities account is a type of account many banks and brokerage firms offer to their customers as a way of safely holding multiple types of investments. Common investments like stocks, bonds, and mutual funds can all be held in a securities account.

Most brokerage firms also give their customers the option of opening what is called a "margin account." A customer who opens a margin account may borrow funds from the brokerage firm and pledge securities as collateral for the loan. If the customer fails to repay the loan, the securities pledged as collateral can be sold by the brokerage firm up to the amount of the unpaid loan. This power to borrow against one's own investments is strictly voluntary on the customer's part. If a customer opens a margin account, there is a specific set of federal regulations that apply to govern the customer's and the lender's rights in

securities.[2]

Importantly, retirement accounts like IRAs and 401(k)s *cannot be margin accounts*. Borrowing against one's investments significantly increases the risk of loss and is not appropriate for retirement savings accounts. For that reason, the Internal Revenue Code in effect prohibits such transactions.[3]

Some employer-sponsored retirement plans do allow employees to borrow a percentage of their retirement account balances. But such a transaction involves taking a loan against the existing balance in the employee's retirement account, not borrowing funds from a bank or broker, and hence is quite different.

To summarize, securities accounts can hold many types of investments. Margin accounts are an option for investors who want a line of credit from their brokerage firm using their investments as collateral. Retirement accounts like IRAs, 401(k)s, and 403(b)s are never margin accounts.

2. The indirect holding system for securities

Historically, securities like stocks and bonds were issued as paper certificates. Each certificate identified the owner by name, and ownership of the stock or bond was tied to possession of the certificate. To sell the security, the owner had to sign the back of the certificate and deliver it to the buyer.

As the volume of trading increased, this system proved to be impossible to maintain. In the mid-1960s a paperwork crisis paralyzed Wall Street as a backlog of paper certificates piled up at brokerage firms causing delays in trade settlement.[4] For a time, the New York Stock Exchange (NYSE) had to close on Wednesdays and hold reduced trading hours on other days in order to allow its members to process backlogged transactions. In some cases, transactions went unfulfilled for weeks after the trade was initiated.

At the time of Wall Street's paperwork crunch, the average daily trading volume on the NYSE was in the range of 10 to 20 million shares. In 2023 the average volume of shares traded on the NYSE was about 100 times that amount, and many more shares trade at other securities exchanges. Obviously, improved trading and settlement systems were necessary to process the increased volume of daily trades and to ensure that trades settle within an acceptable time frame. To meet the demands of the modern economy, a new system was devised in which securities owned by an investor could be held with a central securities depository and credited to the account of the investor's bank or broker, which would in turn credit the account maintained for the investor by means of a computer entry.

For most investors, the indirect holding system for securities that exists today consists of three levels and is best illustrated using an example:

[2] See, e.g., C.F.R. § 240.15c3-3 (often referred to as the "Customer Protection Rule").
[3] See I.R.C. § 4975 (imposing a tax on such a transaction, thus making the transaction economically infeasible).
[4] See, e.g., William F. Jaenike, "The Paperwork Crisis" (2008) available at https://optimizeronline.com/the-paperwork-crisis/ (last accessed Aug. 27, 2024); Wyatt Wells, The Remaking of Wall Street, 1967 to 1971(2000) available at https://hbswk.hbs.edu/archive/the-remaking-of-wall-street-1967-to-1971 (last accessed Aug. 27, 2024).

Level 1: Individual investors

Investor Alice deposits cash into a securities account that she opened with her securities intermediary (which could be a bank or a brokerage firm). Alice then places an order to buy 100 shares of stock of XYZ corporation. Assume for this example that Alice is using her own funds for the purchase, and not using funds borrowed from her securities intermediary. In other words, Alice is not buying securities "on margin" through a margin account. The securities intermediary will credit Alice's securities account with 100 shares of XYZ stock and debit the amount of cash used to make the purchase.

Level 2: Securities intermediaries

Of course, Alice is only one of her broker's many customers. Assume for this example that Alice's securities intermediary (e.g. Fidelity, Charles Schwab, E-Trade, etc.) has 50,000 total customers with securities accounts that, like Alice's account, are not margin accounts. Further assume that collectively those 50,000 customers own 1 million shares of XYZ stock purchased with their own funds. Under federal law and SEC regulations, as well as under UCC Article 8, the firm is required to maintain 1 million shares of XYZ stock for its customers.[5] The firm is not permitted under federal law to loan out or pledge as collateral for its own benefit any of the 1 million shares of XYZ that it is required to hold for its customers.[6] Nor under UCC Article 8 is the firm permitted to pledge the securities without the consent of the customer.[7]

Now consider the transaction from the firm's perspective. On the same Monday that Alice placed her order, it is likely that some of the firm's other customers also placed orders to buy or sell XYZ stock. One of the functions of a securities intermediary is to aggregate the trade orders placed by its customers. If, when Alice ordered a purchase of 100 shares of XYZ stock, another customer of the firm placed an order to sell 100 shares of XYZ, the firm can simply reallocate 100 of the shares of XYZ stock that the firm holds for its customers. In essence, Alice's account is credited with 100 shares, the other customer's account is debited by 100 shares. This type of internal trade settlement involving customers of the same broker is very common.

Some brokerage firms have proprietary positions in the types of securities their investors own – i.e., they hold *more* than the required number of shares owned by the firm's customers. For example, Alice's brokerage firm might own 200,000 shares of XYZ beyond the 1 million shares of XYZ it holds for its 50,000 customers. Under federal law those extra 200,000 shares of XYZ must be segregated from the 1 million shares the firm holds for its customers.[8] By holding proprietary shares, the firm can also process orders to buy or sell XYZ stock from investors who have securities accounts at *other* banks or brokerage houses. When acting in this capacity, the firm is referred to as a "market-maker," or a "liquidity provider." This type of trade between a securities intermediary and outside investors is also very common. And of course, the firm can use its proprietary shares to trade for its

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[5] C.F.R. § 240.15c3-3; UCC § 8-504(a).

[6] 15 U.S.C.A. § 78h; C.F.R. § 240.8c-1 The analysis is different if Alice purchased her XYZ shares in a margin account using funds borrowed from her brokerage firm. In that case, Alice has pledged at least a percentage of her shares to the brokerage firm as collateral, voluntarily giving up some of her rights in exchange for using the firm's money. This process is called "hypothecation" and is used by some investors who choose to accept the risk of loss that comes from using borrowed funds.

[7] UCC § 8-504(b).

[8] 15 U.S.C.A. § 78h.

own benefit, in which case the firm is referred to as a "securities dealer".

Level 3: Clearing corporations

At the end of each trading day, all brokers and banks who act as securities intermediaries must total their customers' purchases and sales of each security to determine how many shares their customers will own upon settlement. For example, Alice's broker could have started the day owning 1 million shares of XYZ for its customers' accounts. Upon settlement of all the trades that were executed, the firm's customers collectively will likely own either more or less than 1 million shares. If the firm's customers bought more XYZ shares than the number of XYZ shares they sold over the course of the day, the total number of shares the firm is required to hold for its customers will increase. Conversely, if the firm's customers sold more XYZ stock than they bought, the firm's required holdings will go down.

Banks and brokers use clearing corporations (a particular type of securities intermediary) to clear and settle securities trades. For securities firms in the United States dealing with publicly traded stocks and bonds of U.S. companies, the use of clearing corporations is generally required. Two major clearing corporations are involved: National Securities Clearing Corporation (NSCC), which compares trades and uses a continuous netting service to "net down" the number of transactions to the smallest number each day, and The Depository Trust Company (DTC), which is the central securities depository through which nearly all publicly traded stock and bonds of U.S. companies are held.[9] Most entities registered with the U.S. Securities and Exchange Commission to trade securities for their investor-customers are participants of NSCC, and hold securities at DTC or through a DTC participant.

The process for settling securities firms' accounts by exchanging securities between securities firms through a clearing corporation such as DTC is similar to the process described above for settling the accounts of individual customers at the same brokerage firm. The central securities depository is itself registered as the owner on the books of the issuer and can electronically credit the balance of one firm's account and electronically debit another firm's account without the underlying securities changing hands.

3. Benefits of the indirect holding system

As a result of this system of indirect holding that developed over the past fifty years, most securities traded on U.S. securities exchanges today are held by clearing corporations rather than by brokerage firms, other securities custodians, or individual investors. By computerizing trading and eliminating the need to deliver paper certificates from seller to buyer, the indirect holding system allows for a far greater volume of securities trades and has reduced the time required for a trade to settle.

C. The Evolution of UCC Article 8

Since the 1950s, UCC Article 8 has provided a comprehensive set of rules for trading and holding investment securities. Article 8 takes no position on the relative advantages of direct and indirect holding of securities – that choice is left to the investor and to the

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[9] In 1973 DTC was formed as a central clearing corporation to hold stock certificates and other types of paper securities on behalf of their owners to facilitate more efficient trading. NSCC was established three years later to net trades and payments among participants. For more information about NSCC, DTC and the parent company the Depository Trust & Clearinghouse Corporation, see https://www.dtcc.com.

company that issues shares of stock or bonds for purchase by investors.

The first version of UCC Article 8, which was enacted by states in the 1950s and 1960s, applied only to the direct holding of securities. At the time, securities were printed as certificates, and to settle trades the seller would sign the certificate and deliver it to the buyer (or the buyer's broker). The original rules in Article 8 were written to facilitate this type of transaction.

Article 8 was amended in 1978 to add rules governing uncertificated securities. These rules permitted companies to issue securities not on paper certificates, but to simply maintain a ledger to keep track of the securities' owners. Many mutual fund shares are held by investors in this manner—i.e., "directly" as registered as owners on the issuer's books.[10]

Over time, the indirect system of holding securities became dominant and required another update to UCC Article 8. Part 5 of UCC Article 8 on Security Entitlements was added in 1994. It includes rules for securities owned by investors but held indirectly through securities intermediaries and clearing corporations as described above. The term "security entitlement" was coined to describe this new form of ownership and is defined in UCC Section 8-102 as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5."[11] Those financial assets are further described in UCC Section 8-501 as assets credited to a person's securities account by a securities intermediary.[12]

The 1994 amendments to UCC Article 8 codified important investor protection rules. For example, UCC Section 8-503 provides that securities held by a securities intermediary for the account of a customer ***are not property of the securities intermediary and not subject to claims of the securities intermediary's creditors*** unless one of the exceptions described below applies.[13] More specifically, to the extent necessary to satisfy the investors to whose accounts securities have been credited, all securities of the type credited to investors' accounts—including securities held in a proprietary capacity— "***are held by the securities intermediary for the [investors]***".[14]

There are two narrow exceptions to the rule. It is these exceptions—which have been the law in all 50 states for more than a quarter-century—that have led some to call for states to amend UCC Article 8. The next section of this paper describes why these exceptions exist and why they do not pose any danger to individual investors or to the investing public generally.

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[10] If the investor holds the mutual fund shares through a securities intermediary in the indirect holding system, the shares are treated much like any other investment security in the indirect holding system. The mutual fund shows on its books the securities intermediary as the registered owner of the shares, and the securities intermediary credits those shares to the securities account of the individual investor.
[11] Importantly, a security entitlement is defined under UCC § 8-102 as a property interest, and not a contract claim. Proponents of amending UCC Article 8 have misstated this fact to legislators to justify the proposed change.
[12] The UCC, like all uniform acts, is drafted using descriptive terms rather than commonly used names for specific things. This is necessary so that the statute, when enacted by a state, cannot be evaded by simply changing the name by which a thing is called. Hence, the broadly defined terms "securities intermediary" rather than "broker," and "security entitlement" rather than "indirectly-owned security."
[13] UCC § 8-511(b)
[14] Id.

D. The purpose of UCC Article 8's priority rules for security entitlements

UCC Section 8-511(a) provides a general rule that applies if the securities intermediary (a bank or brokerage firm) does not have enough securities of a particular issue to satisfy claims of both the securities intermediary's customers and the securities intermediary's secured creditors. The rule is that the customers' claims have priority over the creditors' security interests. This priority rule would typically be applied if a securities intermediary became insolvent *and did not have all the securities it is supposed to have*. Recall, as noted above, that federal laws and SEC regulations, as well as UCC Article 8, require securities intermediaries to hold sufficient assets to satisfy all of its customers' claims to securities.

However, subsections (b) and (c) of UCC Section 8-511 provide two exceptions to the general customer priority rule in UCC Section 8-511(a). These exceptions give secured creditors priority over customers under certain circumstances. The legislation recently proposed in several states would have repealed the exceptions and left the general rule in place, giving the customer priority over the creditors in *all* circumstances. While this proposed legislation was undoubtedly intended to offer additional protection to investors, a deeper analysis will reveal that the proposed alterations to UCC Article 8 are unnecessary and potentially harmful to investors.

1. The alleged doomsday scenario

Proponents of the legislation to amend UCC Article 8 have stated that the exceptions to the general priority rule in UCC Section 511(a) could cause an investor's retirement account balance to "vanish" overnight.[15] They contend that if a securities intermediary becomes insolvent, UCC Section 8-511(b) would allow the creditors of the intermediary to seize assets belonging to investors and held by the securities intermediary for investors' accounts. This is false.

UCC Article 8 is designed to—and does—work harmoniously with other state and federal laws to protect the property rights of securities owners. In the United States, the issuance, initial sale, and resale of most securities is regulated under federal law, as are the major securities exchanges and their member firms who act as securities brokers and dealers.[16] In particular, the Securities Exchange Act of 1934, the Securities Investor Protection Act of 1970, the Internal Revenue Code, and associated regulations issued by the U.S. Securities and Exchange Commission prevent the misuse of an investor's securities by a securities intermediary or clearing corporation that holds the property for the investor's account.[17]

The scenario envisioned by proponents of the changes to UCC Section 8-511 involves a securities intermediary who pledges all of the securities in a customer's retirement account

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[15] A letter sent to legislators in several states stated: "Imagine waking up one morning and logging into your IRA or 401(k) account to see how it is performing. To your shock and horror, there is nothing there; your account balance is $0. Through no actions of your own, your stocks and bonds have vanished. This might sound impossible, but it could happen under current law in the event of a financial crisis. The full letter is available at https://heartland.org/wp-content/uploads/2024/01/1-26-24-UCC-Article-8-State-Legislative-Alert_Final.pdf, last accessed Aug. 27, 2024

[16] For a list of federal securities laws and accompanying regulations, see https://www.sec.gov/rules-regulations/statutes-regulations, last accessed Aug 27, 2024. State laws regulating securities apply mainly to securities that are exempt from federal regulation because, for one example, the market for the security is limited to investors from a single state.

[17] See statute and regulations cited at notes 2 and 3, *supra.* See also the Securities Investor Protection Act of 1970, 15 U.S.C.A. § 78aaa et seq.

as collateral for a loan. This would be both highly illegal, and as a practical matter, impossible.

First, investments held in retirement accounts like IRAs and 401(k)s cannot be pledged as collateral. Doing so would be a prohibited transaction under the Internal Revenue Code.[18]

In non-retirement accounts, it is illegal under both federal and state law for a securities intermediary to use a customer's securities for its own benefit. Federal regulations require that "a broker or dealer shall promptly obtain and thereafter maintain the physical possession or control[19] of all fully paid securities[20] carried by a broker or dealer for the account of customers."[21] UCC Article 8 also provides, subject to federal regulations, that "a securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset" and "except to the extent otherwise agreed by its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain."[22]

In other words, securities intermediaries are required by law to hold their customers' investments (either directly or indirectly through another securities intermediary) and are not permitted to pledge their customers' investments as collateral for the firm's borrowing without the customer's consent. Any person who violates this law is subject not only to civil damages to make the investors whole again, but also to severe criminal penalties.[23]

But even if a securities intermediary were willing to risk violating the law, the securities intermediary is a regulated entity, subject to periodic audits and reporting requirements by the SEC or banking regulators. The SEC ensures compliance with customer protection rules, and the bank regulators likewise ensure the protection of bank customers.

For all of the above reasons, it is incorrect to suggest that a person's investment property could "vanish" because of claims by a securities intermediary's creditors.

2. The purpose of the priority rules in UCC Section 8-511

Once again, federal laws and SEC regulations require securities intermediaries to "promptly obtain" and "maintain the physical possession or control"[24] of all securities held for the account of their customers.[25] UCC Article 8 has a similar rule.[26] To understand what that means, recall the example of Alice's brokerage account. Alice placed the order on Monday, and her broker "promptly obtained" the 100 shares of XYZ stock by settling the trade through its clearing corporation. The shares were credited to Alice's account by

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[18] I.R.C. § 4975

[19] C.F.R. § 240.15c3-3(c) provides that "possession or control" allows for the intermediary to either physically possess certificates or to control those certificates by holding them in an account with a securities clearing corporation under an indirect holding system.

[20] Fully paid securities are those purchased with the customer's funds, and not on margin.

[21] C.F.R. § 240.15c3-3(b). Exceptions apply for temporary lags while trades settle, for margin accounts, and for securities subject to a written repurchase agreement.

[22] UCC § 8-504.

[23] Individual violators may be fined up to $5 million and imprisoned for up to 20 years. Businesses may be fined up to $25 million. 15 U.S.C.A. § 78ff.

[24] C.F.R. § 240.15c3-3(b).

[25] This rule is not applicable to customers who purchase securities using borrowed funds in margin accounts.

[26] UCC § 8-504(a).

Tuesday. Alice's brokerage firm then "maintained control" of the shares by holding them in its account at the clearing corporation for the benefit of Alice.

When an investor owns securities that are held indirectly by a securities intermediary, UCC Section 8-501 establishes that the investor has a *security entitlement* to the investment property, and UCC Section 8-503 establishes that the investment property *belongs to the entitlement holder* and is not subject to claims of the intermediary's creditors unless one of the exceptions in Section 8-511 applies.

Unfortunately, we all know that laws can be broken. If a securities intermediary fails in its duties to maintain control of enough securities for the accounts of all its customers, there are consequences. Federal law provides for criminal and civil penalties as described above.[27] UCC Section 8-511 provides the practical rules that govern who receives the insufficient number of securities that the securities intermediary does control.

The general rule is simple, and more protective of investors than the law as it existed prior to 1994.[28] UCC Section 8-511(a) provides that, if a securities intermediary has not maintained a sufficient number of a particular type of security to satisfy both its customer's accounts and creditor claims, the customer's claims have a higher priority and the customers are entitled to receive all of the securities available. UCC Sections 8-511(b) and (c) provide two narrow exceptions to this general rule.

a) UCC Section 8-511(b) exception

To illustrate one common and widely understood circumstance when the exception in UCC Section 8-511(b) would apply, return to the earlier example.

Recall from the discussion above that Alice's brokerage firm may offer financing to its customers to enable them to acquire securities on margin. If Alice wished to obtain credit rather than pay for the securities in full, she would need to open a margin account with her brokerage firm. Many customers find this option desirable. Margin accounts are subject to a specific set of federal regulations.[29] If Alice, or other customers chose to purchase securities on margin, these securities could be available for the brokerage firm to use as collateral for the loan.[30] This circumstance is one in which the exception in UCC Section 8-511(b) could apply.

To elaborate, in order for Alice or another investor to obtain financing from the brokerage firm, the brokerage firm will take a security interest in the securities carried in the margin account, thus becoming a secured creditor[31] of the investor. If Alice defaults on the terms of her credit, she can lose the securities she pledged as collateral to the extent necessary to repay the loan from the firm. In order for the brokerage firm to provide this financing to the investor, the firm will in turn need to obtain financing. This is typically accomplished by

[27] See Note 23, *supra.*
[28] See James Steven Rogers, *"Policy Perspectives on Revised U.C.C. Article 8,"* 43 UCLA Law Review 1431 at 1526 (concluding that "…the major respect in which the rules set out in Section 8-511 alter present law is a change in favor of the position of customers.")
[29] 12 CFR Part 220.
[30] Subject to the rules governing rehypothecation – see Note 6, *supra.*
[31] A "secured creditor" is a lender who takes a security interest in specific property as collateral for a loan. See UCC §§ 1-102(b)(35) and 9-101(a)(73).

borrowing from a bank lender.[32] The bank will, in turn, require (and indeed is usually required by regulation to acquire) a security interest in the subject securities (the securities Alice or the other investor purchased on margin), thus becoming a secured creditor of the brokerage firm. The granting of the security interest, as noted above, requires the investor's consent, but the financing obtained by the investor is conditioned on this arrangement.

UCC Section 8-511(b) says that a secured creditor of a securities intermediary (the brokerage firm) would have priority as to any shares of XYZ over which that creditor has "control" within the meaning of the UCC. Ordinarily the bank lender to the brokerage firm would, in fact, have "control," because the bank would be the securities intermediary through which the brokerage firm holds its securities positions.[33] Why is the rule designed to permit this outcome?

First, as just noted, some customers elect to open margin accounts to obtain credit from their brokerage firm and voluntarily pledge their securities as collateral. Brokers can offer margin credit to these customers because the law allows them, *only with their customers' express permission,* to grant a security interest in those securities to the very lender providing the funds to the brokerage firm to extend the margin credit. Any contrary rule would effectively prevent a brokerage firm from obtaining secured credit, because the creditor could never be assured of priority to the collateral. The contrary rule would harm the brokerage firm's customers who want margin accounts.

Second, the regulatory infrastructure discussed above which limits the extent to which a brokerage firm can encumber "customer" assets is designed to ensure that the investor's interest in the subject securities will not be impaired. This is because the amount of the investor's interest is limited to the amount for which it has paid the purchase price (i.e., the value of the securities purchased less the amount borrowed to acquire the securities). Moreover, the brokerage firm's customers are protected under the federal Securities Investor Protection Act.[34] That law requires brokerage firms to be members of the Securities Investor Protection Corporation (SIPC) which insures investment accounts for up to $500,000 per individual investor, and retirement accounts for up to an additional $500,000 per account. This insurance is in place to protect investors against a brokerage firm's insolvency, similarly to how FDIC insurance protects bank deposits. As a practical matter, individual investors' accounts at the brokerage firm would usually be transferred to a solvent securities intermediary so the investors do not lose access to their securities during the time it takes for the brokerage firm to be liquidated.

Third, a secured creditor, like any other innocent party, has its own obligations to its own customers and creditors. The fact that one brokerage firm became subject to an insolvency proceeding should not be the start of a chain reaction affecting investors with accounts at other firms and potentially threatening the greater economy. The UCC Section 8-511(b) exception ensures that responsible lenders who protect themselves by legally holding investment property as collateral can access that collateral if the loan is not repaid.

Finally, although the secured creditor has priority in collateral under the limited

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[32] Often the lender is a "clearing bank" that acts as custodian for both the firm's proprietary securities and (in segregated accounts) securities owned by the firm's customers.
[33] UCC § 8-106(e).
[34] 15 U.S.C. § 78aaa, et seq.

circumstances described in UCC Section 8-511(b), UCC Section 8-503(e) itself removes this priority if the secured creditor is acting in collusion with the brokerage firm in violating the firm's obligation to its customers. Under that subsection, the customers, acting through an insolvency representative for the brokerage firm, could set aside the security interest and recover their interests or, if the insolvency representative elects not to pursue that right, an entitlement holder whose security entitlement remains unsatisfied has the right to recover its interest in the financial asset from the secured creditor.[35]

In summary, the UCC Section 8-511(b) exception benefits individual investors by facilitating the ability of investors to purchase securities on margin with borrowed funds.[36] The exception also benefits the general investing public by ensuring that one firm's insolvency is contained. Additionally, customers of any firm that becomes insolvent are protected by SIPC insurance.

b) UCC Section 8-511(c) exception

UCC Section 8-511(c) contains an additional exception that gives priority to secured creditors of clearing corporations. If a securities intermediary becomes insolvent and fails to deliver shares or cash to a clearing corporation as required to settle its own or its customers' trades, the clearing corporation has a special role to play, as illustrated with the following example.

Suppose that instead of buying, Alice sold 100 shares of XYZ stock through her broker. On the other side of that trade, some other investor purchased 100 shares of XYZ stock. If the other investor's broker failed to deliver the cash purchase price for the 100 shares to the clearing corporation for any reason, Alice's sale might fail.

The rule under UCC Section 8-511(c) ensures that Alice's trade can settle on time. Under the indirect holding system that exists today, the clearing corporation can settle Alice's trade by borrowing from a lender to provide the cash purchase price to Alice for the 100 shares of XYZ stock. But this borrowing (like the financing provided by a broker's clearing bank) will be conditioned on the lender obtaining a security interest in collateral sufficient to protect the lender against loss.

The exception in UCC Section 8-511(c) ensures that banks are willing to lend to clearing corporations and can accept any securities held by the clearing corporations as collateral. To reiterate the point made above, none of the securities used as collateral could be "fully paid" customer securities.

Though this type of borrowing is very rare, it serves an important purpose. Because the clearing corporation can settle trades as expected, a problem that affects one securities intermediary can be contained, rather than starting a chain-reaction of failed trades at other securities intermediaries. The entire system is protected for the benefit of all investors.

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[35] UCC § 8-511, cmt.1; UCC § 8-503(d).

[36] Other types of transactions can also implicate UCC Section 8-511(b). For example, an investor selling securities "short" and using the proceeds to buy other securities could result in a lender taking a security interest. The general point remains: the obligation of an intermediary to maintain sufficient assets for its investors' accounts, and the limited right of the intermediary to create a security interest in favor of its own creditor that would have priority over the interest of its customer in specific circumstances when the customer has consented to the arrangement, are both extensively prescribed and proscribed by federal law and regulation.

E. Conclusion

Amending UCC Article 8 to remove the exceptions in UCC Section 8-511(b) and (c) is not necessary to protect investors and would significantly impede commerce.

If even one state enacted a non-uniform version of UCC Section 8-511, any legal dispute would potentially require analysis and resolution of difficult choice-of-law issues to determine which state's law applies to the dispute. That is precisely what the sponsors of the UCC tried to avoid when drafting it, and one of the goals that the legislatures in all fifty states sought to achieve when enacting the UCC. Interstate business thrives because the UCC makes transactions predictable. If any state's law differs from the laws of other states, businesses will have to learn about, plan for, and potentially contract around those differences. This adds unnecessary legal expenses into otherwise routine commercial transactions.

Amending UCC Article 8 would also harm individual investors in the state by limiting their access to credit. Securities brokers are unlikely to offer margin accounts to their customers if the loans would be unsecured.

UCC Article 8 has operated as its drafters intended in conjunction with other federal and state laws to protect investor interests for nearly 30 years. Since UCC Article 8 was approved by the Uniform Law Commission and the American Law Institute in 1994, several securities intermediaries have failed, the largest being Lehman Brothers, Inc. during the 2008 recession. Individual customers with investment accounts at Lehman Brothers, Inc. had their accounts quicky transferred to a solvent brokerage firm along with all of their investment assets.[37] No individual investors lost any of their assets in the transfer, while larger investors had the chance to litigate their claims in court. Indeed, no individual investors have ever suffered a loss by virtue of UCC Article 8's limited exceptions to the general rule giving investors priority over creditors to securities held by their securities intermediaries.

In summary, UCC Article 8 does not pose any danger to individual investors. The general rule in UCC Section 8-511 ensures that individual investors have priority over a firm's creditors in most circumstances. The two narrow exceptions to the general rule serve to provide individual investors with access to credit, and to ensure that a single firm's insolvency is contained and can be resolved fairly without harming individual investors.

[37] https://libertystreeteconomics.newyorkfed.org/2019/01/customer-and-employee-losses-in-lehmans-insolvency/, last accessed Aug. 27, 2024.