



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

**March 21, 2024**

### 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 firm'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 the provisions benefit investors.

### Q&A

#### **What is Article 8 of the UCC?**

The Uniform Commercial Code (UCC) is a set of rules enacted in every state that govern commercial transactions in the United States. They allow commerce to proceed predictably and give Americans the confidence to do business with each other across state lines.

The law of securities (stocks, bonds, and other types of investments) is a combination of federal and state law. Federal laws govern the issuance and registration of securities and regulate securities firms and exchanges to ensure investors are treated fairly and their investments are kept safe. UCC Article 8 governs securities transactions, providing rules to clarify the rights of buyers and sellers. Together, these laws protect the interests of investors and provide additional benefits like access to credit and assurance that a single investment firm's insolvency can be resolved quickly and fairly without harming individual investors.

These rules, which were approved by the Uniform Law Commission and the American Law Institute in 1994 have protected investor interests for 30 years, help promote efficiency and reduce the risk of legal disputes over financial transactions.

## **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 an intermediary, rather than holding paper certificates. 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. Because the securities are not property of the intermediary, they are not subject to the claims of the intermediary's creditors. That is, the investors will not lose their assets even if the intermediary becomes insolvent.

Proponents of legislation to amend UCC Article 8 have focused on two narrow exceptions that apply only in special situations, and they misunderstand the purpose and effect of those rules. 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 intermediary to purchase securities and pledge the securities as collateral to secure payment of the loan. Or the investor may permit the intermediary to lend out securities to third parties, with the customer receiving a payment for doing so. Under these voluntary arrangements, Article 8 gives priority to the lender who has accepted securities as collateral.

The other exception deals with clearing corporations. Clearing corporations are the companies that hold securities under the indirect holding system used by most investors today. Article 8 gives priority to clearing corporations if they have to borrow securities to settle trades between intermediaries. This priority ensures that, in the event a securities intermediary becomes insolvent, the insolvency will not affect individual investors and other intermediaries who traded with the insolvent firm.

## **What would happen if these exceptions are repealed through state legislation?**

The proposed alterations to UCC Article 8 are unnecessary and potentially harmful to investors.

Investors would be deprived of using their securities to obtain margin loans or to obtain additional income, and the commonly used indirect system of holding securities, with all of its advantages for modern trading practices, would be undermined.

Repealing these provisions of Article 8 would also significantly impede commerce. Interstate business thrives because the UCC makes transactions predictable. If laws differ between states, companies will have to learn about, plan for, and potentially contract around those differences. This adds unnecessary legal expenses to the otherwise routine commercial transactions that have operated under the UCC since 1994.

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

No individual investor has **ever** suffered a loss because of 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 intermediaries, including Lehman Brothers, failed during the 2008 recession. Individual customers who had investment accounts at Lehman and who had not consented to Lehman repledging their securities had their accounts quickly transferred to a solvent brokerage firm along with all their securities.

## In-Depth Analysis

### A. The Purpose of the Uniform Commercial Code

The UCC is a set of rules to govern commercial transactions. Many of the UCC's rules are default rules that only apply when the parties to a transaction have not made a different agreement. The UCC is extremely detailed because it attempts to provide rules for situations that fall outside the range of normal commercial activity.

To illustrate, consider the example of buying stock as an investment. The terms of the sale probably will not address the buyer's and seller's rights if the seller accidentally delivers the stock to the wrong person, or if the buyer's payment is denied by the buyer's bank. The UCC, however, provides a rule for these situations.

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 § 8-511. To explain why that provision should not be changed, it is helpful to understand two concepts underlying much of UCC Article 8: brokerage accounts, and indirect holding of securities.

#### 1. Brokerage accounts

A brokerage account is a type of account many banks and brokerage firms offer to their customers as a way of safely holding various types of investments. Common investments like stocks, bonds, and mutual funds can all be held in a brokerage 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 their securities (e.g. shares owned by the investor) 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.<sup>1</sup>

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

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<sup>1</sup> [12 CFR Part 220](#)

prohibits such transactions.<sup>2</sup>

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, brokerage 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 on 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.<sup>3</sup> 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, which in some cases 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, an improved trading system was necessary to process the increased volume of daily trades and to ensure trades settle within an acceptable time frame. To meet the demands of the modern economy, a new system was devised in which securities could be owned by an investor but kept on deposit with a central clearinghouse and credited to the investor's brokerage account by means of a computer entry.

The indirect holding system for securities that exists today consists of three-tiers and is best illustrated using an example:

### *Tier 1: Individual investors*

Investor Alice deposits cash into a brokerage account that she opened with her financial 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 intermediary. In other words, Alice is not buying securities "on margin" through a margin account. The financial intermediary will buy 100 shares of XYZ stock, and then credit Alice's account with 100

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<sup>2</sup> See [I.R.C. § 4975](#) (imposing a tax on such a transaction that makes the transaction economically infeasible).

<sup>3</sup> See, e.g., William F. Jaenike, "The Paperwork Crisis" (2008) available at <https://optimizeronline.com/the-paperwork-crisis/> (last accessed Feb. 9, 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 Feb. 9, 2024).

shares of XYZ stock and debit the amount of cash used to make the purchase.

Stock trades normally settle two days after the trade is placed. If Alice ordered the purchase of XYZ stock on a Monday, when the stock market closes on Wednesday afternoon Alice's account will show that she owns 100 shares of XYZ Corporation.

### *Tier 2: Securities intermediaries*

Of course, Alice is only one of her broker's many customers. Assume for this example that Alice's brokerage firm (e.g. Fidelity, Charles Schwab, E-Trade, etc.) has 50,000 total customers with 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, the firm is required to maintain 1 million shares of XYZ stock for its customers.<sup>4</sup> 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.<sup>5,6</sup>

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 brokerage firm 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, but no trade occurs on the applicable stock exchange. This type of internal trade involving customers of the same broker is very common.

Some brokerage firms opt to hold *more* than the required number of shares owned by the firm's customers. For example, Alice's brokerage firm might hold an extra 200,000 shares of XYZ beyond the 1 million shares it holds for its 50,000 customers. Under federal law those extra 200,000 shares of XYZ must be held in the firm's own account and cannot be combined with the 1 million shares the firm holds for its customers.<sup>7</sup> By holding these extra shares, the firm can also process orders to buy or sell XYZ stock from investors who

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<sup>4</sup> [C.F.R. § 240.15c3-3](#)

<sup>5</sup> [15 U.S.C.A. § 78h](#); [C.F.R. § 240.8c-1](#)

<sup>6</sup> 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 additional risk of loss that comes from using borrowed funds.

In this latter scenario, the firm is also allowed to repledge or loan out Alice's XYZ shares in a process called "rehypothecation." But a firm that rehypothecates securities also is required to maintain for its margin customers a reserve bank account. The firm must deposit to the reserve account U.S. government or government guaranteed securities with a value sufficient to cover the value of the loaned securities.

These rather complicated rules exist to protect customers in the event a brokerage firm becomes insolvent. In any bankruptcy proceeding, the value available to satisfy customer claims will include the value of customer equities in securities (meaning the amount the customer owns, less the amount the customer borrowed) and the balance of the reserve account. To simplify, these rules are intended to ensure that value will be available in an insolvency proceeding to satisfy customer claims even when customer securities are rehypothecated and, practically, that rehypothecation transactions are permitted only for the benefit of customers who have margin accounts, and not for the benefit of the firm.

<sup>7</sup> [15 U.S.C.A. § 78h](#).

have brokerage accounts at *other* banks or brokerage houses. When acting in this capacity, the firm is referred to as a “securities dealer,” a “market-maker,” or a “liquidity provider.” This type of trade between a brokerage firm and outside investors is also very common.

### *Tier 3: Central clearinghouses*

At the end of each trading day, all brokers and banks who act as financial intermediaries must total their customers’ purchases and sales of each security to determine how many shares their customers now own. For example, Alice’s broker could have started the day owning 1 million shares of XYZ for its customers’ accounts. At the end of the day after all trades 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.

Brokerage houses use a central clearinghouse to settle securities trades with each other. For securities firms in the United States dealing with stocks of U.S. companies, that clearinghouse is the Depository Trust Company (DTC).<sup>8</sup> Most securities intermediaries registered with the U.S. Securities and Exchange Commission to trade securities for their investor-customers are participants of DTC or hold securities through a DTC participant.

The process for settling securities firms’ accounts by exchanging securities between securities firms through a clearinghouse is similar to the process described above for settling the accounts of individual customers at the same brokerage firm. The clearinghouse can electronically credit the balance of one firm’s account and electronically debit another firm’s account without the paper certificates (if any) actually 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 clearinghouses rather than by brokerage firms or by 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. However, trades are still not instantaneous—there is a lag between the time a customer like Alice places her order and the time the shares appear in her account. This fact is important to understand the reason for the rules contained in UCC § 8-511.

### 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 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,

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<sup>8</sup> In 1973 a consortium of brokerage companies formed the Depository Trust Company (DTC) as a central clearinghouse to hold stock certificates and other types of paper securities on behalf of their owners to facilitate more efficient trading. For more information about DTC and its parent company the Depository Trust & Clearinghouse Corporation, see <https://www.dtcc.com>. Other clearinghouses exist for other types of securities, e.g. bonds, options, foreign stocks, etc.



applied only to 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. If the owner held the shares in a brokerage account, the ownership would also be indicated on the account holder's brokerage statement. Many mutual fund shares are still traded in this manner.

Over time, the system of indirect holding of securities became dominant and required another update to Article 8. Part 5 of Article 8 on Security Entitlements was added in 1994. It includes rules for securities owned by investors but held indirectly through securities intermediaries and clearinghouses as described above. The term "security entitlement" was coined to describe this new form of ownership and is defined in UCC § 8-102 as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5."<sup>9</sup> Those financial assets are further described in UCC § 8-501 as assets credited to a person's securities account by a securities intermediary.<sup>10</sup>

The 1994 amendments to Article 8 codified important investor protection rules. For example, UCC § 8-503 provides that securities held by an intermediary for the account of a customer are not property of the intermediary and not generally subject to claims from the intermediary's creditors. 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 and to the investing public generally.

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

UCC § 8-511(a) provides a general rule that applies if the securities intermediary (a bank or brokerage firm) does not have enough shares of a particular security to satisfy claims of both the intermediary's customers and the 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 an intermediary became insolvent *and did not have all the securities it is supposed to have*. Recall, as noted above, that federal law requires securities intermediaries to hold enough of each security to satisfy all of its customers' claims to that security.

However, subsections (b) and (c) provide two exceptions to the general rule that 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

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<sup>9</sup> Importantly, a security entitlement is defined under the UCC as a property interest, and not a contract claim. Proponents of amending Article 8 have repeatedly misstated this fact to legislators to justify the proposed change.

<sup>10</sup> The Uniform Commercial Code, 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."

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 doomsday scenario

Proponents of the legislation to amend Article 8 have stated that the exception to the general priority rule in UCC § 511 could cause an investor's account balance to "vanish" overnight.<sup>11</sup> They contend that if a securities intermediary becomes insolvent, UCC § 8-511(b) would allow the creditors of the intermediary to seize assets belonging to the investor and held by the securities intermediary for the investor's account. 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.<sup>12</sup> 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 clearinghouse who holds the property for the investor's account.<sup>13</sup>

The scenario envisioned by proponents of HB 1199 involves a securities intermediary who pledges all of the securities in a customer's retirement account 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.<sup>14</sup>

In non-retirement accounts, it is illegal under both federal and state law for a financial intermediary to use a customer's securities for its own benefit. Setting aside the situation where a customer opens a margin account to obtain credit from the intermediary, federal regulations require that "a broker or dealer shall promptly obtain and thereafter maintain the physical possession or control<sup>15</sup> of all fully paid securities<sup>16</sup> carried by a broker or

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<sup>11</sup> 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](https://heartland.org/wp-content/uploads/2024/01/1-26-24-UCC-Article-8-State-Legislative-Alert_Final.pdf), last visited on Mar. 19, 2024

<sup>12</sup> For a list of federal securities laws and accompanying regulations, see <https://www.sec.gov/about/about-securities-laws#invadvact1940> (last visited Mar. 19, 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.

<sup>13</sup> See statute and regulations cited at notes 4 and 5, *supra*. See also the Securities Investor Protection Act of 1970, [15 U.S.C.A. § 78aaa et seq.](#)

<sup>14</sup> [I.R.C. § 4975](#)

<sup>15</sup> [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 clearinghouse under an indirect holding system.

<sup>16</sup> Fully paid securities are those purchased with the customer's funds, and not on margin.



dealer for the account of customers.”<sup>17</sup> 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.”<sup>18</sup>

In other words, intermediaries are required by law to hold their customers’ investments (either directly or indirectly through a clearinghouse) and are not permitted to pledge their customers’ investments as collateral for the firm’s borrowing. 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.<sup>19</sup>

But even if an intermediary were willing to risk violating the law, as a practical matter, registered broker-dealers are regulated entities, subject to periodic audits and reporting requirements by the SEC. It would be highly improbable that a firm could hide illegal activity from regulators for any length of time. Moreover, the banks that lend to securities intermediaries are fully aware of the applicable securities regulations and the types of collateral that are acceptable under the law.

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 exceptions in UCC § 8-511

Federal law requires securities intermediaries to “promptly obtain” and “maintain the physical possession or control”<sup>20</sup> of all securities held for the account of their customers.<sup>21</sup> 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 clearinghouse later that day. The shares were credited to Alice’s account by Wednesday. Alice’s brokerage firm then “maintained control” of the shares by holding them in its account at the clearinghouse for the benefit of Alice.

When an investor owns securities that are held indirectly by an intermediary or a clearinghouse, UCC § 8-503 establishes that the investor is an *entitlement holder* with a property right in the investment property, and that the property is not subject to claims of the intermediary’s creditors unless one of the exceptions in § 8-511 applies.

UCC § 8-511(a) provides the general rule that in the event an intermediary has not maintained control of sufficient shares of a particular security to satisfy both its customer’s accounts and creditor claims, the customer’s claims have a higher priority. UCC § 8-511(b) and (c) provide two narrow exceptions to this general rule.

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<sup>17</sup> [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.

<sup>18</sup> Uniform Commercial Code § 8-504.

<sup>19</sup> 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](#).

<sup>20</sup> [C.F.R. § 240.15c3-3\(b\)](#).

<sup>21</sup> This rule is not applicable to customers who purchase securities using borrowed funds in margin accounts.

*a) UCC § 8-511(b) exception*

To illustrate when the exception in UCC § 8-511 (b) would apply, return to the earlier example. Recall that at the end of each trading day, Alice's brokerage firm must reconcile its customers' accounts. We assumed that at the beginning of the day, the firm was required to hold 1 million shares of XYZ stock that were owned collectively by its 50,000 customers.

At the end of the trading day, after netting the purchases and sales of Alice and its other customers, the brokerage firm has a new holding requirement. Rather than 1 million shares, it might be required to hold .95 million shares, if its customers sold more XYZ than they bought, or 1.05 million shares if the customers bought more XYZ than they sold.

The same federal regulation that requires securities intermediaries to maintain possession or control of their customers' investment property makes clear that this type of short-term discrepancy does not violate the rule.<sup>22</sup> If the firm discovers at the end of the day that it is required to obtain another 50,000 shares of XYZ because of its customers' combined daily purchases, the firm is allowed a reasonable time within which to obtain those securities. If the securities are held at a clearinghouse like DTC, the additional required shares can be quickly purchased from another intermediary who has shares available to sell. If the shares are not held at a clearinghouse, the intermediary can purchase them through a securities exchange within a reasonable time to fulfill its obligation. This type of short-term, relatively small discrepancy between the number of shares owned by the firm's customers and the number of shares held by the firm is not only legal under federal law, it occurs daily as securities intermediaries settle their customers' trades.

Ordinarily brokerage firms will reconcile their accounts and meet their holding requirements before trading opens the next day. But consider what would happen if Alice's brokerage firm declared it was insolvent and filed for bankruptcy before reconciling its customers' accounts with the day's trades. At the moment of the filing, the firm will hold more than the required amount of some securities (e.g. ABC Corp.), and less than the required amount of other securities, (e.g. XYZ Corp.).

Recall from the discussion above that Alice's brokerage firm may also offer margin accounts to its customers. Margin accounts are subject to a different set of federal regulations.<sup>23</sup> In addition to the shares of XYZ the firm is required to hold for the account of Alice and its other customers, the firm could also own additional shares of XYZ through margin accounts that it is allowed to pledge as collateral.<sup>24</sup> If this combination of factors

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<sup>22</sup> The SEC regulation states: "A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section [which requires the broker or dealer to continually possess or control all of its customers' investments] regarding physical possession or control of customers' securities if, solely as the result of normal business operations, temporary lags occur between the time when a security is required to be in the possession or control of the broker or dealer and the time that it is placed in the broker's or dealer's physical possession or under its control, provided that the broker or dealer takes timely steps in good faith to establish prompt physical possession or control. The burden of proof shall be on the broker or dealer to establish that the failure to obtain physical possession or control of securities carried for the account of customers as required by paragraph (b)(1) of this section is merely temporary and solely the result of normal business operations including same day receipt and redelivery (turnaround), and to establish that it has taken timely steps in good faith to place them in its physical possession or control." [17 CFR 240.15c3-3\(b\)\(2\)](#)

<sup>23</sup> [12 CFR Part 220](#)

<sup>24</sup> Subject to the rules governing rehypothecation – see Note 6, *Supra*.

exists, and the brokerage firm has ceased operations because it filed for bankruptcy, the firm could hold fewer shares of XYZ than is necessary to satisfy claims of both its customers and its secured creditors and the exception in UCC § 8-511(b) could apply.

A “secured creditor” is a lender who takes a security interest in specific property as collateral for a loan. UCC § 8-511(b) says that a secured creditor would have priority as to any shares of XYZ that the creditor “controls.” This means the lender would have priority with respect to any shares that were transferred from the brokerage firm’s account to be held in the lender’s account as collateral until the loan was repaid.

To review the facts of the example and apply UCC § 8-511:

1. At the start of the day, the brokerage firm held 1 million shares of XYZ for its customers’ accounts.
2. At the start of the day, the brokerage firm also owned some additional shares of XYZ in its own account, and had pledged those additional shares as collateral for a loan, transferring control to its lender.
3. At the end of the trading day, the brokerage firm’s customers bought 50,000 more shares of XYZ than they sold, increasing the number of shares brokerage firm was required to hold for its customers from 1 million to 1.05 million. Before purchasing the additional shares, the brokerage firm files for bankruptcy.
4. Under the rule in UCC § 8-511(a), the brokerage firm’s customers have priority to the 1 million shares of XYZ held for their accounts. This figure is 50,000 shares fewer than the number of shares required to satisfy all its customers’ claims.
5. Under the exception in UCC § 8-511(b), the brokerage firm’s secured creditor has priority with respect to the additional shares owned by the brokerage firm for its own account and transferred to the lender as collateral.

Why is the rule designed to produce this outcome?

First, recall that 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 relend those securities for profit. 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. This would not benefit the brokerage firm’s customers who want margin accounts.

Second, the brokerage firm’s customers are protected under the Securities Investor Protection Act. 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 \$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.

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 filed for bankruptcy should not be the start of a chain reaction affecting other firms and potentially threatening the greater economy. The UCC § 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 circumstances described in UCC 8-511(b), under the general principle of UCC 8-503(e), if the secured creditor is acting in collusion with the brokerage firm to defraud the firm's customers, the customers, acting through an insolvency representative, could set aside the security interest and recover their investments anyway.<sup>25</sup>

#### *b) UCC § 8-511(c) exception*

UCC § 8-511(c) contains an exception giving priority to clearing corporations that operates under similar principles. If a securities intermediary becomes insolvent and fails to deliver shares or cash to a clearinghouse as required to settle its customers' trades, the clearinghouse has a special role to play.

Returning to the example as an illustration, Alice purchased 100 shares of XYZ stock through her broker. On the other side of that trade, some other investor sold 100 shares of XYZ stock. If the other investor's broker failed to deliver the 100 shares to the clearinghouse for any reason, Alice's purchase might be invalid.

The rule under UCC § 8-511(c) ensures that Alice's trade can settle on time. Perhaps the other broker was affected by a natural disaster, or a medical emergency, or some other circumstance that prevented it from meeting its obligations. Under the indirect holding system that exists today, the clearinghouse can settle Alice's trade anyway by borrowing the 100 shares of XYZ stock. Though this type of borrowing is very rare, it serves an important purpose. Because the clearinghouse can settle trades as expected, a problem that affects one intermediary can be contained, rather than starting a chain-reaction of failed trades at other intermediaries. The entire system is protected for the benefit of all investors.

The exception in UCC § 8-511(c) ensures that banks are willing to lend to clearinghouses and can accept securities as collateral. In a temporary emergency as described above, the loan is ordinarily repaid quickly and investors are unaware. But in the event of an intermediary's insolvency, a clearinghouse may have to rely on its line of credit for a longer period of time. In this circumstance, individual investors' accounts would be transferred to a solvent firm so they do not lose access to their property while the clearinghouse's obligation to its creditors can be addressed in an orderly bankruptcy proceeding.

#### *E. Conclusion*

Amending Article 8 to remove the exceptions in UCC § 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 § 8-511, any legal dispute would potentially require analysis and resolution of a difficult choice-of-law issue to determine

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<sup>25</sup> [T]he claim of a secured creditor of a securities intermediary has priority over the claims of entitlement holders if the secured creditor has obtained control. If, however, the secured creditor acted in collusion with the intermediary in violating the intermediary's obligation to its entitlement holders, then under Section 8-503(e), the entitlement holders, through their representative in insolvency proceedings, could recover the interest from the secured creditor, that is, set aside the security interest. (Unif. Commercial Code § 8-511, Comment 1.)

which state's law applies to the dispute. That is precisely what the sponsors of the Uniform Commercial Code tried to avoid when drafting it, and one of the goals that the legislatures in all fifty states sought to achieve when enacting it. 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. Investors could also lose the option to enter into repurchase agreements under which they temporarily loan their shares to short-sellers for a fee. Companies in a state that amends Article 8 would lose the ability to borrow against their securities holdings for cash flow.

UCC Article 8 has operated as its drafters intended in conjunction with other federal and state laws to protect consumer interests for nearly 30 years. Since revised UCC Article 8 was approved by the Uniform Law Commission and the American Law Institute in 1994, several financial intermediaries have failed, the largest being Lehman Brothers during the 2008 recession. Individual customers with investment accounts at Lehman Brothers had their accounts quickly transferred to a solvent brokerage firm along with all of their investment assets.<sup>26</sup> No individual investors lost any of their assets in the transfer, while larger investors had the chance to litigate their claims in bankruptcy court. Indeed, no individual investors have ever suffered a loss by virtue of Article 8's limited exceptions to the general rule giving investors priority over creditors to securities held by their investment intermediaries.

In summary, UCC Article 8 does not pose any danger to individual investors. The general rule in UCC § 8-511 ensures 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 a single firm's insolvency is contained and can be resolved quickly and fairly without harming individual investors.

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<sup>26</sup> <https://libertystreeteconomics.newyorkfed.org/2019/01/customer-and-employee-losses-in-lehmans-bankruptcy/>, last visited Feb. 9, 2024.