



A DIVISION OF WALLBUILDERS

## **Protecting Private Property Through the Uniform Commercial Code**

Dear State Legislators and Other Elected Officials,

Questions are now being raised about important laws that have been added to state codes in all 50 states over the past 25 years. These laws were deliberately designed to abrogate private property rights and could in the future be used to harm all Americans who hold investment securities, including those held in IRA and 401(k) accounts. At the state level, the concerning statutes in question are contained within the Uniform Commercial Code (UCC), primarily in Article 8, which deals with securities. UCC Article 8 is dense and complicated, and until recently, very few outside the financial industry have understood the full implications of this law.

This letter explains our concerns, summarizes the legal aspects of UCC Article 8, and outlines near-term options for state policymakers who want to take action to protect their constituents and their states.

Here is some background for context. Over the past few years, the world's largest financial institutions, those often referred to as "too big to fail," have been quietly preparing for a potential global financial crisis. One of the ways in which they have done this is by lobbying legislators to change the way collateral is held under state laws, to reposition banks to have priority claim over the wealth stored in investments, 401(k), and IRA accounts. The result of their efforts is that Article 8 of the UCC effectively nullifies citizens' fundamental property rights over their investments.

What does this mean for your constituents? A simple example illustrates the concern: 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. How is this possible?

Under existing legal and contractual agreements, if you were to call your broker today to put in an order to buy 100 shares of Apple, you might think the resulting purchase of 100 shares constitutes ownership, but it does not. Your broker would add the 100 shares to your account, but all you would actually own is a "security entitlement" to the shares, not the shares themselves. A security entitlement is essentially a contract with your broker granting certain rights to a security such as stock. While this will surprise most people, it is clearly and intentionally laid out in Article 8 of the UCC.

In 1994, the Uniform Law Commission (ULC) established a drafting committee to revise UCC Article 8. The revised Article 8 was presented to state legislatures and passed into law over the next several years. The rationale for the revision was that the previous version of UCC Article 8 did not address the rapid evolution from paper stock and bond certificates to digital (uncertificated) securities that began in earnest in the 1980s.

The 1994 revision included several significant provisions that turned our common understanding of property rights on its head. First, as mentioned above, the drafting committee created a new form of “property rights” for investment securities called a “security entitlement.” The result is that you do not actually own the underlying stock or bond. You only “own” certain contractual rights with your broker. But this is just the beginning.

Article 8 also provides priority to protected creditors if they pledge customer assets as collateral—in our example above, the 100 shares of Apple stock. That means if a customer’s broker-dealer were to become insolvent, the broker’s secured creditors would be given priority to the customer’s security entitlement. Under a widespread collapse of the financial system, or even just the collapse of a single large broker, potentially millions of individual investors would find themselves as unsecured creditors in an insolvency proceeding, putting them at the back of the line to attain access to the securities they think they already own.

In his groundbreaking book *The Great Taking*—which galvanized many of the questions that inspired our research into the UCC—David Rogers Webb explains,

Essentially, all securities ‘owned’ by the public in custodial accounts, pension plans and investment funds are now encumbered as collateral underpinning the derivatives complex, which is so large—an order of magnitude greater than the entire global economy—that there is not enough of anything in the world to back it. The illusion of collateral backing is facilitated by a daisy chain of hypothecation and re-hypothecation in which the same underlying client collateral is re-used many times over by a series of secured creditors. And so it is these creditors, who understand this system, who have demanded even more access to client assets as collateral.<sup>1</sup>

If the financial markets continue to operate relatively normally, the changes made to Article 8 would likely continue to have little impact for individual investors. However, if there were to be a large crash in the financial markets—think of the 2008 housing bubble, only far worse—the stocks and bonds we think we own could be swept away in the aftermath, all to the benefit of too-big-to-fail financial institutions. At present, there is simply nowhere near enough collateral to cover all the debt and other obligations currently spread throughout the financial markets to ensure that such a “great taking” does not occur.

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<sup>1</sup> David Rogers Webb, *The Great Taking*, November 28, 2023, TheGreatTaking.com, <https://thegreataking.com/read-online-or-download>

A review of the current UCC,<sup>2</sup> contemporaneous writings by law professors,<sup>3</sup> the ULC drafting committee's comments,<sup>4</sup> and a simultaneously enlightening and concerning exchange between the U.S. Federal Reserve Bank of New York and the European Commission's Legal Certainty Group<sup>5</sup> clearly indicate that the threat is real.

In fact, this exact scenario has already played out on a small scale, and it has been ratified by U.S. courts. These legal decisions have cemented into law the assertion that large financial institutions have priority over customer assets.

For example, when Lehman Brothers filed for bankruptcy during the 2008 financial crisis, one of its primary lenders was JP Morgan Chase Bank. A subsidiary of JP Morgan Chase was Lehman's custodian, of both Lehman's own assets and the assets of Lehman's customers. As custodian, JP Morgan Chase had control of Lehman's assets, and as lender, JP Morgan Chase had a security interest in Lehman's assets. As a result of the changes to UCC Article 8—as well as a 2006 change to federal bankruptcy law—JP Morgan Chase was able to take all of Lehman's accounts as collateral for the loans that Lehman could no longer pay. Webb concludes that “the bankruptcy of Lehman Brothers was used to establish case law precedent that the ‘protected class’ of secured creditors have an absolute priority claim to client assets, and that, potentially and practically, only they will end up with the assets.”<sup>6</sup>

You may be asking yourself, why would the UCC drafting committee include such provisions in their recommendations for state lawmakers? It's a good question, and the answer only makes sense when you understand the true objective of the 1994 UCC Article 8 revision and the composition of the drafting committee.

The lead drafter of the 1994 revision wrote an overview of the committee process and stated clearly that the primary motivation behind the work was to prepare for a potential collapse of U.S. financial markets.<sup>7</sup> However, the revised Article 8 does not alleviate or minimize the threat of a collapse. What the revised Article 8 does do, though, is protect large financial institutions in

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<sup>2</sup> Uniform Law Commission, *UCC Article 8, Investment Securities*, uniformlaws.org, accessed January 10, 2024, <https://www.uniformlaws.org/committees/community-home?CommunityKey=f93a92b2-020f-4bfa-880b-5f80d24d018d>

<sup>3</sup> For a selection of these writings, see: Francis J. Facciolo, “Father Knows Best: Revised Article 8 and the Individual Investor,” *Florida State University Law Review*, Volume 27, Issue 616, 2000, <https://www.stjohns.edu/sites/default/files/uploads/facciolo-father-knows-best.pdf>; Russell A. Hakes, “UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day,” *Loyola of Los Angeles Law Review*, Volume 35, Issue 3, April 2002, <https://digitalcommons.lmu.edu/cgi/viewcontent.cgi?article=2318&context=llr>; Kathleen Patchel, “Interest Group Politics, Federalism, and the Uniform Law Process: Some Lessons from the Uniform Commercial Code,” *Minnesota Law Review*, Volume 78, 1993, <https://scholarship.law.umn.edu/cgi/viewcontent.cgi?article=2733&context=mlr>

<sup>4</sup> The American Law Institute and the National Conference of Commissioners on Uniform State Laws, *U.C.C. – Article 8 – Investment Securities (Revised 1994)*, Published by Cornell University Law School, Legal Information Institute, January 2003, [https://assistingvessels.files.wordpress.com/2012/05/ucc8\\_investment-securities.pdf](https://assistingvessels.files.wordpress.com/2012/05/ucc8_investment-securities.pdf)

<sup>5</sup> Federal Reserve Bank of New York, “EU Clearing and Settlement, Legal Certainty Group, Questionnaire,” March 6, 2006, <https://ia802601.us.archive.org/32/items/ec-clearing-questionnaire/EuCommission2005a.pdf>

<sup>6</sup> David Rogers Webb, *The Great Taking*.

<sup>7</sup> James S. Rogers, “Policy Perspectives on Revised U.C.C. Article 8,” *UCLA Law Review* 1431, 1996, accessed from Boston College Law School Faculty Papers, <https://lira.bc.edu/work/ns/81b6ffe2-96c3-4087-b991-c70aaa870a47>

the event of a future systemic financial collapse, as the relatively small-scale Lehman Brothers example illustrates.

The revised UCC Article 8 includes a significant threat to private property and the financial affairs of individual investors. But this threat can be neutralized. Because the UCC is a state law, state lawmakers can take steps to protect their constituents. There are many provisions within UCC Article 8 that should be scrutinized, as well as provisions in other UCC articles dealing with private property rights that should be addressed, such as Article 9. Comprehensively examining each of these provisions will take time. However, policymakers could take action in the immediate term to restore some semblance of private property rights. In particular, they should focus on ensuring that individual investors have priority over security entitlements held by brokerage firms and other security intermediaries. Additionally, policymakers should consider altering jurisdictional provisions in Article 8 so that cases are determined in the state of the individual investor, rather than the state of the broker-dealer, custodian, or clearing corporation.

Such efforts to address the concerns mentioned above will also serve to broaden public awareness. Currently, most individual investors are completely unaware of this threat to their financial assets, which could result in a taking that occurs without their knowledge or action. This does not represent informed consent.

We suspect that if state policymakers begin to take steps to protect the private property interests of their constituents, the largest banks and financial institutions will protest loudly. They will argue that making changes to Article 8 will threaten our financial system and the economy at large. But nothing could be further from the truth. Allowing massive institutions, many of which are worth hundreds of billions of dollars, to have priority over security entitlements belonging to individual investors creates massive distortions in the marketplace that could ultimately hasten a large economic crash. But even if this were not the case, an important question for policymakers remains: Is a system truly worthy of saving if it would happily sacrifice individual investors' wealth to save allegedly too-big-to-fail institutions?

We, the undersigned organizations and individuals, encourage lawmakers to closely examine Article 8 of the UCC, review its contents for any provisions that would pose significant risks to citizens' property rights, and then to take action to secure those rights.

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***\*For Identification Purposes Only***