State of New Hampshire

Commerce and Consumer Affairs Committee

Re: HB 427

AN ACT relative to amending the uniform commercial code

Testimony of David Rogers Webb

January 23, 2025

Since their beginnings more than **four centuries** ago, **financial instruments** were recognized **under law everywhere** as **personal property.**

Perhaps that is why they were called “**securities**”!

Certainty of CONTROL

Dematerialization
was the essential first step.

Indirect holding system

“Beneficial Ownership”

Appearance of a property right

Does not function as a direct property right in the event of insolvency in the financial system.

Directly connected
with the derivatives bubble

Key facts:

- **Ownership of securities as property** has been replaced with a new legal concept of a **"security entitlement”**, which is a **contractual claim** assuring a very weak position if the account provider becomes insolvent. **ALL securities** are held in **un-segregated pooled form**.
- **Securities used as collateral, and those restricted from such use, are held in the same pool.**

- ALL account holders **(including those who have prohibited use of their securities as collateral)** must, by law, **receive only a pro-rata share of residual assets**.
- “Re-vindication”(the **taking back of one’s own securities** in the event of insolvency) is **absolutely prohibited**.

- Account providers may legally borrow pooled securities **without restriction** and **free of payment (FOP)** to collateralize proprietary trading and financing.
- **"Safe Harbor"** assures **secured creditors** priority claim to pooled securities **ahead of account holders even if fraudulently transferred**.
- Absolute priority claim of secured creditors to pooled client securities has been **upheld by the courts**.

How can we know this?

In **April of 2004**, The **European Commission Internal Markets and Services Director General** proposed the

"setting up of group of legal experts, as a specific exercise intended to address problems of ***legal uncertainty*** *identified in the context of considering the* ***way forward*** *for clearing and settlement in the European Union".*

This became the **Legal Certainty Group**.

The **objective** was to make it

Legally certain

that **secured creditors**

would be **empowered** to

Immediately take client assets

in the event of **failure of an intermediary**.

In **March of 2006**,

the **Deputy General Counsel** for the

Federal Reserve Bank of New York provided

a **detailed response** to a **questionnaire** prepared by

The Legal Certainty Group.

The following are excerpts from that response:

https://archive.org/details/ec-clearing-questionnaire/page/1/mode/2up

Q (E.U.): *"In respect of what legal system are the following answers given?"*

A (N.Y. Fed): *"This response confines itself to U.S. commercial law, primarily* ***Article 8 . . . and parts of Article 9, of the Uniform Commercial Code ("UCC")*** *. . . The subject matter of Article 8 is 'Investment Securities' and the subject of Article 9 is 'Secured Transactions.' Article 8 and Article 9* ***have been adopted throughout the United States****."*

Q (E.U.): *"Where securities are held in* ***pooled form*** *(e.g. a collective securities position, rather than segregated individual positions per person),* **does the investor have rights attaching to particular securities in the pool?"**

A (N.Y. Fed): *"****No****. The security entitlement holder . . . has a* ***pro rata share*** *of the interests in the financial asset held by its securities intermediary . . . This is* ***true even if investor positions are 'segregated****."'*

Q (E.U.): *“Is the **investor protected** against the **insolvency** of an **intermediary** and, if so, how?”*

A (N.Y. Fed): *" . . . an **investor** is **always vulnerable** to a **securities intermediary** that **does not itself have** interests in a financial asset **sufficient to cover** all of the **securities entitlements** that **it has created** in that financial asset . . .*

*If the **secured creditor has "control"** over the financial asset it **will have priority** over entitlement holders . . .*

*If the securities intermediary is a **clearing corporation**, the claims of* **its** ***creditors have priority*** *over the claims of entitlement holders."*

Q (E.U.): *"What rules protect a **transferee** acting in good faith?"*

A (N.Y. Fed): *"**Article 8 protects a purchaser** of a financial asset **against claims** of an **entitlement holder** to a **property interest** in that financial asset, by **limiting the entitlement holder's ability to enforce that claim** . . . Essentially, **unless the purchaser was involved** in the **wrongdoing** of the securities intermediary, an **entitlement holder** will be **precluded** from raising a claim against it."*

Q (E.U.): *"How are **shortfalls** . . . (i.e. the intermediary's position with an upper-tier intermediary is less than the aggregate recorded position of the intermediary's account-holders) . . . handled in practice?"*

A (N.Y. Fed): *" . . . The **only rule** in such instances is that the security **entitlement holders simply share pro rata** in the interests held by the securities intermediary . . .*

*In actual fact, shortfalls occur frequently due to fails and for other reasons, but are of no general consequence except in the case of the **securities intermediary's insolvency**."*

Q (E.U.): *"Does the treatment of shortfalls differ according to whether there is (i) no fault on the part of the intermediary, (ii) if fault, fraud or (iv)* ***if fault, negligence or similar breach of duty?"***

A (N.Y. Fed): *"In terms of the interest that the entitlement holders have in the financial assets credited to its securities account:* ***regardless of fault, fraud, or negligence of the securities intermediary****, under Article 8, the* ***entitlement holder has only a pro rata share*** *in the securities intermediary's interest in the financial asset in question."*

Swedish law was identified by the Legal Certainty Group as problematic.

Sweden had complied
with the G30 mandate for dematerialization,
but had implemented a system
which assured direct ownership rights
(specific identification),
and that customer securities
could not be used as collateral
without written agreement.

UCLA Law Review 1431 (1996)

POLICY PERSPECTIVES ON REVISED U.C.C. ARTICLE 8

James Steven Rogers, Professor, Boston College Law School

The author **served as Reporter** to the Drafting Committee to **Revise U.C.C. Article 8**.

https://core.ac.uk/download/pdf/80409974.pdf

…concerns…have been expressed *in some quarters about the relationship between the* ***Article 8*** *rules and legal regimes for the* ***protection of the interests of individual investors.***

…circumstances in which the claims of persons, including ***secured creditors****, to whom a* ***securities intermediary*** *has* ***wrongfully*** *transferred securities have* ***priority over the claims of customers of a failed intermediary****.*

43 UCLA LAW REVIEW P. 1434

…this issue was given very careful consideration during the drafting process

*…a **very large number** of **thoughtful lawyers**, many of whom **started from the standpoint of unease** about the rule, have concluded, **after careful consideration**, that their **initial impressions were incorrect** and that the rules set out in Revised Article 8 are **entirely sound** from all perspectives, including that of individual investors.*

43 UCLA LAW REVIEW P. 1435

*The work of which the Article 8 revision project is a part might be described as **"Armageddon planning"** for the financial system.*

*There are, thankfully, people in **both governmental bodies and private sector groups** who devote a significant portion of their professional activities to **contemplating what might happen in the event of major crises in the financial system…***

43 UCLA LAW REVIEW P. 1436

Historically, under U.S. Bankruptcy Code,
a bankruptcy trustee could avoid transfers, i.e., force disgorgement, if the transfer was
‘constructively fraudulent’.

In 2005, less than two years before onset of the Global Financial Crisis,

"safe harbor" provisions in the U.S. Bankruptcy code were significantly changed.

This was about "safe harbor" for secured creditors **against claims of customers to their own assets**.

With the new “safe harbor” provisions, the transfer of customer assets to creditors **previously considered to be fraudulent** can **no longer be challenged**.

Further, it is now quite OK for the transfer of the pooled securities to be made free-of-payment (FoP), as there is **no requirement to show that reasonably equivalent value was received**.

Stephen J. Lubben is the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University and an expert corporate finance and governance, corporate restructuring, financial distress and debt.

The Bankruptcy Code Without Safe Harbors:

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1569627

Following the 2005 amendments to the Code, it is ***hard to envision a derivative that is not subject to special treatment****.*

The ***safe harbors cover a wide range of contracts that might be considered derivatives . . .*** *most importantly,* ***swap agreements.*** *The latter has become* ***a kind of 'catch-all' definition that covers the whole of the derivatives market, present and future . . .***

A protected contract . . . is ***only protected if the holder is also a protected person****, as defined in the Bankruptcy Code.*

Financial participants—essentially very large financial institutions—are always protected.

In the failure of Lehman Brothers, **JP Morgan (JPM)** had **taken client assets** as a **secured creditor** while being the **custodian for these client assets!**

Under long-standing bankruptcy law **this would clearly have been a constructively fraudulent preference transfer benefitting an insider**.

And so, JPM was sued by clients whose assets were taken.

Here is the decision of the court:

UNITED STATES BANKRUPTCY COURT SOUTHERN DISTRICT OF NEW YORK In re: Chapter 11 Case No. 08-13555

https://www.nysb.uscourts.gov/sites/default/files/opinions/198038_134_opinion.pdf

The Court agrees with JPMC that the safe harbors apply here, *and it is appropriate for these provisions to be enforced as written and* ***applied literally in the interest of market stability****.*

The transactions in question are ***precisely the sort of contractual arrangements that should be exempt from being upset by a bankruptcy court under the more lenient standards of constructive fraudulent transfer or preference liability:***

these are systemically significant transactions ***between sophisticated financial players*** *at a time of financial distress in the markets—in other words,* ***the precise setting for which the safe harbors were intended. . . .***

The Court first must consider whether JPMC is eligible for protection *under section 546(e). That subsection, like the* ***safe harbors*** *generally,* ***applies only to certain types of qualifying entities. . . .***

JPMC, as one of the leading financial institutions in the world, ***quite obviously is a member of the protected class*** *and qualifies as both a "financial institution" and a "financial participant.*

A (N.Y. Fed): *" . . . an **investor** is **always vulnerable** to a **securities intermediary** that **does not itself have** interests in a financial asset **sufficient to cover** all of the **securities entitlements** that **it has created** in that financial asset . . .*

*If the **secured creditor has "control"** over the financial asset it **will have priority** over entitlement holders . . . "*

Lehman did not itself have interests in financial assets sufficient to cover all of the securities entitlements that it had created in those financial assets.

How were these entitlements created?

Within days of the bankruptcy,
Lehman had used customer assets
to secure swap contracts
with JPM.

JPM knew customer assets were being used.

JPM was also the custodian for client assets.

JPM had secured CONTROL of the client assets.

This was not investigated as criminal wrongdoing.

No one was prosecuted.

No one went to jail.

They were paid bonuses.

CONSTRUCTIVELY FRAUDULENT PREFERENCE TRANSFER BENEFITING AND INSIDER

Less than ‘reasonable equivalent value’ was received, and the debtor in bankruptcy

- was insolvent,
- became insolvent as a result of the transfer,
- was engaged in business with too little capital,
- incurred debt beyond ability to pay,
- the transfer was for the benefit of an insider;

or

- the transfer was made within 90 days of bankruptcy (one year if the transferee was an insider).

The **2014** BIS report,

Developments in collateral management services,

discloses collateral management systems,

which provides **cross-border mobility**

of collateral from the

“**collateral giver**” to the “**collateral takers**”.

https://www.bis.org/cpmi/publ/d119.pdf

*The **desired end goal***

of all these efforts

is to get as close as possible to a

***single view** of **all available securities**,*

regardless of where they are held,

in real time.

This aggregation of supply information is a

necessary prerequisite

for the efficient

deployment of available securities

to meet collateral obligations.

With this information,

the ICSD runs its optimisation process and may

automatically generate collateral allocation instructions

for the ***collateral giver/takers*** *based on the results . . .*

the ICSD will also

process the movement of securities *. . .*

. . . it is possible that efforts

to make more efficient use of

existing collateral will not be sufficient

to fully satisfy individual obligations.

. . . ***market participants may need to exchange*** *available, but* ***ineligible, securities*** *for other securities that meet eligibility criteria in order to* ***fulfill their collateral obligations****.*

Undertaking transactions
to achieve this outcome
has been defined as
“collateral transformation.”

*In **times of market stress,***

rapid deployment

of available securities may be

***crucial in mitigating systemic issues**.*

For instance, with better visibility of available securities

and ***better access to them****,*

firms may be better positioned to

rapidly deploy

securities to meet margin needs at CCPs

in times of ***increased market volatility***

or to ***pledge to central banks in emergency situations***

to gain increased access to ***the lender of last resort****. . . .*

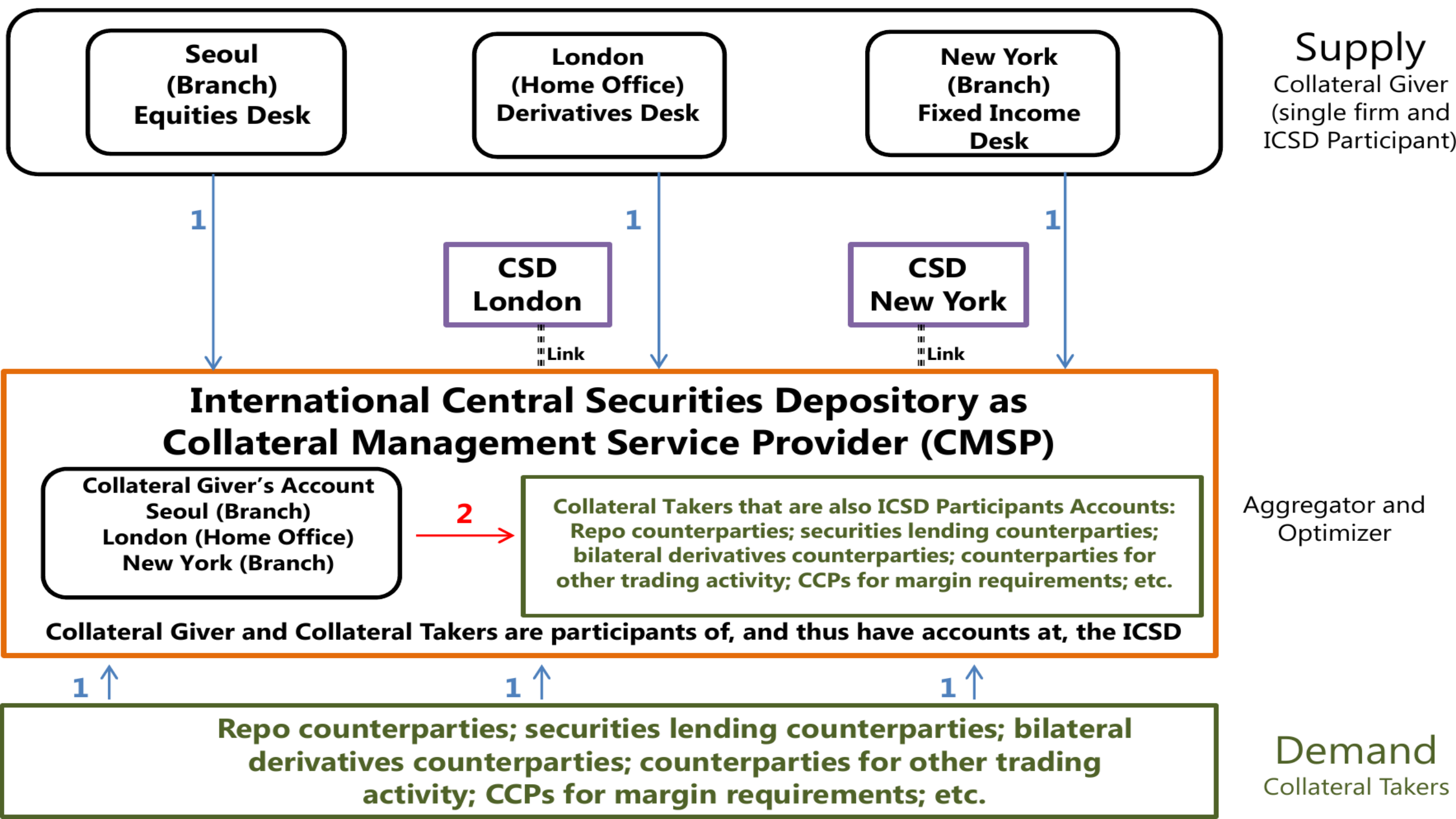
*The **automation** and **standardisation***

of many operations related to

***collateral management** . . . on a **market-wide basis** . . .*

may enable a market participant to manage

increasingly complex** and **rapid collateral demands.


Seoul (Branch) Equities Desk
London (Home Office) Derivatives Desk
New York (Branch) Fixed Income Desk
Supply
Collateral Giver (single firm and ICSD Participant)
1
1
1
CSD London
CSD New York
Link
Link
International Central Securities Depository as Collateral Management Service Provider (CMSP)
Collateral Giver's Account
Seoul (Branch)
London (Home Office)
New York (Branch)
2
Collateral Takers that are also ICSD Participants Accounts: Repo counterparties; securities lending counterparties; bilateral derivatives counterparties; counterparties for other trading activity; CCPs for margin requirements; etc.
Aggregator and Optimizer
Collateral Giver and Collateral Takers are participants of, and thus have accounts at, the ICSD
1
1
1
Repo counterparties; securities lending counterparties; bilateral derivatives counterparties; counterparties for other trading activity; CCPs for margin requirements; etc.
Demand
Collateral Takers

GLOBAL FINANCIAL CRISIS

CENTRAL CLEARING OF DERIVATIVES

Now recall these excerpts from the exchange between the Legal Certainty Group and lawyers for the Federal Reserve:

If the securities intermediary is a clearing corporation, the claims of its creditors have priority over the claims of entitlement holders.

Central Clearing Counterparties (CCPs) take on counterparty risk between parties to a transaction and provide clearing and settlement for trades in foreign exchange, securities, options, and **most importantly derivative contracts**.

If a participant fails, the CCP assumes the obligations of the failed clearing participant.

The CCP combines the exposures to all clearing members on its balance sheet.

Is there a risk that CCPs might fail?

As of June 30, 2024, the consolidated Total Shareholder's Equity of DTCC was **$4.1 billion (that's with a "b").**

As for resolution procedures,
DTCC is opposed to pre-funding
the ***default loss waterfall,***
although it does support ***pre-funding***
the operating capital needed
to get a ***new CCP*** *up and running*
in the event of a default.

https://www.marketsmedia.com/dtcc-details-risk-management-approach/

"As we go through our recovery and resolution ***planning*** *we want to have the operating capital* ***pre-funded*** *to potentially* ***start up a new CCP*** *in the event of the resolution of one of our CCPs."*

*“We definitely **see the logic** in having the operating capital **to start up a new CCP pre-funded.**”*

POZMANTER

Derivatives are financial contracts on everything imaginable and even unimaginable for most of us.

They may be modeled on real things . . .
but are **not real things themselves**.

They are untethered from physical reality . . .
but can be used to take real things as collateral.

This is the subterfuge, the endgame of all of this.

Because they are pooled, all securities “owned” by the public in custodial accounts, pension plans and investment funds, can be 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.

Securities Industry and Financial Markets Association (“SIFMA”)

Managing Director and Associate General Counsel

“...regardless of whether ownership
is demonstrated via electronic certificate,
or on paper,
the customer’s property rights remain
the same.”

“Holding in street name...
in no way diminishes
a customer’s
ownership rights.”

“Investors who choose
to hold their securities in street name
with their brokers
are protected by a range of regulations
dedicated to ensuring that client assets
are appropriately controlled and segregated
from the assets of the broker.”

“These securities
cannot be borrowed, lent or traded
without the customer’s consent.”

Uniform Law Commission

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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

March 21, 2024

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.

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****.*

…**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**.

...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****.*

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.***

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.***

This is NOT about margin loans!

It is about creditors of the intermediaries,
not of the clients!

For centuries,
owners could use their securities
to secure “margin loans”,
as they had control of their collateral.