POLICY TIP SHEET

Revising the Uniform Commercial Code to Protect Americans' Property Rights and Impede a U.S. Central Bank Digital Currency

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THE PROBLEM

- Certain current provisions of and proposed amendments to the Uniform Commercial Code (UCC) contain multiple highly problematic elements that pose a threat to the American people and the U.S. economy as a whole.
- Proposed amendments to UCC Article 9 unnecessarily encourage the adoption of a U.S. central bank digital currency (CBDC) by laying the foundation for the use of CBDCs in commercial transactions.
- The current version of UCC Article 9 would already be compatible with the imposition of a U.S. CBDC by the federal government.
- CBDCs are being widely considered as the currency of the future by most countries, including the United States, with the Biden administration particularly supportive.
- CBDCs would allow central planners to engineer society in accordance with their every objective, with no accountability or oversight.
- UCC Article 8 has abrogated Americans' property rights to their own securities and given ownership priority of those securities to secured creditors of securities intermediaries, typically in the form of the "too-big-to-fail" financial institutions.
- In the event of a widescale financial crisis, Americans could easily lose the securities they think they own to secured creditors of potentially insolvent securities intermediaries.
- Such an instance—albeit on a smaller scale—has already occurred during the Lehman Brothers bankruptcy in the 2008 financial crisis, and has been ratified by U.S. courts.

THE SOLUTIONS

- State policymakers could consider resisting changes to the UCC and other state legal codes that would make it easier for financial institutions to adopt a CBDC in the future.
- Legislators could revise the definition of "deposit accounts" in the UCC and state legal codes so that a CBDC could not be used as a "deposit" in state-regulated banks.
- State legislators could ensure that individual investors have priority over security entitlements held by brokerage firms and other securities intermediaries.
- State legislators could also ensure that any insolvency proceedings related to bankrupted securities intermediaries are determined in the jurisdiction of the individual investor, rather than the state of the broker-dealer, custodian, or clearing corporation.

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UCC Background

Important provisions in the Uniform Commercial Code (UCC) contain highly problematic elements that undermine Americans' individual rights and threaten the stability of the U.S. economy. This *Tip Sheet* will provide a brief description of those troubling areas of the UCC and propose a set of related concrete policy solutions for lawmakers.

> **Important provisions in the Uniform Commercial Code (UCC) contain highly problematic elements that undermine Americans' individual rights and threaten the stability of the U.S. economy.**

The UCC was created in the mid-twentieth century by the Uniform Law Commission—an influential organization of practicing lawyers, judges, legislators, legislative staff, and law professors. The ULC frequently proposes updates and revisions to the UCC to this day, and it, along with the American Law Institute, is the driving force behind the vast majority of UCC legislative proposals. According to its website, the ULC "provides states with non-partisan, well-conceived and well-drafted legislations that brings clarity and stability to critical areas of state statutory law."[1]

The ULC notes that the Uniform Commercial Code "is a comprehensive set of laws governing all commercial transactions in the United States."

The ULC further explains, "It is not a federal law, but a uniformly adopted state law. Uniformity of law is essential in this area for the interstate transaction of business. Because the UCC has been universally adopted, businesses can enter into contracts with confidence that the terms will be enforced in the same way by the courts of every American jurisdiction. … For this reason, the UCC has been called 'the backbone of American commerce.'"[2]

As the ULC has rightly explained, the UCC is a vital set of laws that allows for commercial activity to be conducted in a relatively cohesive manner across all 50 states. Because commercial activity and technology are always changing, it is prudent for lawmakers to occasionally update the UCC.

Unfortunately, because the UCC is dense and complicated, very few people and organizations understand it. Over the past few decades, the ULC and others have taken advantage of this confusion by proposing changes to the UCC that few people in the public fully grasp or even learn about. Furthermore, because the ULC has a longstanding positive reputation among state legislators, policymakers frequently make changes to the UCC that have been proposed by the Uniform Law Commission without fully understanding the potential ramifications of their decisions.

Two important examples of this involve the proposed 2022 amendments to UCC Article 9—which deals with secured transactions—and past changes to UCC Article 8—which focuses on investment securities. Although many policymakers do not know it, the ULC's 2022 proposed alterations to Article 9 would help pave the way for a U.S. central bank digital currency. The amendments made to UCC Article 8, which were passed in the 1990s, have abrogated Americans' property rights to their own securities, including those contained within retirement accounts, such as 401(k) accounts.

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Article 9: CBDCs

Central bank digital currencies (CBDCs) have only recently become a widely discussed topic among influential figures in academia, media, and public policy institutions.[3] However, initiatives to implement CBDCs around the globe have existed for years, especially in countries with autocratic governments, such as China and Russia. As of September 2023, 131 countries are considering the use of CBDCs.[4] The Biden administration has also signaled that it is supportive of a Federal Reserve-backed CBDC. In fact, the White House and Federal Reserve have been studying and designing potential U.S. CBDCs for much of Biden's first term in office.[5]

A programmable CBDC—the only kind of CBDC the Biden administration appears interested in pursuing—would almost certainly pose a significant threat to individual liberty, because it would allow central planners at the Federal Reserve to engineer society in accordance with their every objective, with little accountability or oversight. A programmable CBDC could be tracked, manipulated, or even "deleted" by a central governing authority, likely the Federal Reserve. Thus, CBDCs pose a tremendous threat to privacy, freedom, democratic institutions, and society at large.

Although the Uniform Commercial Code cannot create a CBDC, it can be altered to set the table for a future CBDC, by making various commercial transactions easier to conduct in a world where one exists. And that is precisely what ULC advocates have been attempting to do over the past two years.

In 2022, the ULC and the American Law Institute proposed new revisions to the UCC, many of which would provide valuable improvements to states' commercial laws.[6] However, the 2022 amendments to the UCC also included language that unnecessarily encourages the adoption of a CBDC by laying the foundation for the use of CBDCs in commercial transactions. Further, the 2022 amendments do nothing to fix the existing parts of the UCC code that already allow for the use of CBDCs.

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CBDCs and the 2022 UCC Amendments

As we suggested previously, nothing within the 2022 amendments to the UCC would or could create or necessitate the creation of a CBDC. The best legal scholars suggest that the creation of a publicly available U.S. CBDC could only occur as a result of an act of Congress, although it is possible the Biden administration or a future president could attempt to develop a CBDC using executive action. The concerns outlined in this *Tip Sheet* are focused on how UCC laws could be used to help expedite the use of a CBDC in the future, not create one.

It is also important to note that this *Tip Sheet's* analysis of the 2022 UCC amendments addresses issues pertaining specifically to the Uniform Law Commission's version of the 2022 amendments. Some lawmakers have already sought to make additional changes to 2022 UCC amendments, which means multiple versions of the 2022 amendments now exist.

The ULC's amendments to Article 9 of the UCC relate to CBDCs in multiple ways. For example, the 2022 Article 9 amendments would establish the category of "electronic money" specifically to account for the creation of a CBDC and its use by consumers and institutions outside of a deposit account.[7] Further, the amendments would allow for a person or organization to have "exclusive control" of a CBDC without the use of a deposit account. Exclusive control is important in some commercial arrangements, especially those related to lending.

The 2022 UCC Article 9 amendments would also add special provisions so that a programmable CBDC could be used even if it is easily controlled by a centralized authority. More specifically, Article 9 would allow for the "exclusive control" requirement to be met "even if … The electronic money, a record attached to or logically associated with the electronic money, or a system in which the electronic money is recorded, limits the use of the electronic money or has a protocol programmed to cause a change, including a transfer or loss of control."[8]

Additionally, the 2022 amendments would redefine "money" so that existing cryptocurrencies—which, unlike CBDCs, are typically decentralized[9]—could never be considered "money" under the UCC. The 2022 amendments would clearly establish that "money" under the UCC "does not include an electronic record that is a medium of exchange recorded and transferable in a system that existed and operated for the medium of exchange before the medium of exchange was authorized or adopted by the government."[10]

Because all existing cryptocurrencies, including Bitcoin, are "electronic records" serving as a "medium of exchange" prior to being adopted as "money" by the U.S. government, all cryptocurrencies currently in existence would be prevented from qualifying as "money" under the UCC. Importantly, this would be true under the UCC regardless of whether Congress were to designate a cryptocurrency like Bitcoin as money in the future.

Instead of being classified as "money," the UCC amendments would designate cryptocurrencies as "controllable electronic records." Though there might be economic benefits to the latter designation, updating the UCC so that only a CBDC is considered "money" unjustifiably privileges CBDCs over all existing cryptocurrencies, including Bitcoin, in debates about the future of money in the United States.

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CBDCs and the Current UCC

Beyond these changes, the existing, pre-2022 amendments version of the UCC already allows for the use of a programmable CBDC. Policymakers opposing the use of CBDCs should consider making changes to the code that would make it more difficult for CBDCs to be used in commercial activities. The 2022 UCC amendments do not achieve this goal, or even attempt to do so. As we previously noted, it would have the opposite effect.

Under the existing UCC, money placed into a bank account legally becomes a "deposit account." The current UCC's provisions related to deposit accounts do nothing to halt the use of a programmable CBDC. As such, if a U.S. CBDC were created by a federal law tomorrow, it would instantly be compatible with many parts of the existing UCC, but only if users choose or are required to deposit CBDCs into a bank or Federal Reserve account—which, in our opinion, is highly likely to be part of a CBDC design.

Article 8: Property Rights

In 1994, the Uniform Law Commission established a drafting committee to revise UCC Article 8. The ULC revised Article 8 and then presented its amendments to state legislatures. Over the next several years, lawmakers in all 50 states passed those important amendments, fundamentally transforming property rights related to investment securities, including stocks, bonds, exchange-traded funds, and most investments included in retirement accounts.

The stated rationale for the revisions was that the previous version of UCC Article 8 did not address the rapid evolution occurring in the financial sector from paper stock and bond certificates to digital (uncertificated) securities. This transition began in earnest in the 1980s. Moreover, the lead drafter of the 1994 UCC revisions stated that the primary motivation behind the work was to prepare for a potential collapse of U.S. financial markets.[11]

Under the revised UCC Article 8, individuals, organizations, or businesses that purchase a security investment are not the owner of the security. Instead, they become the owner of a securities contract called a "security entitlement." The revisions to Article 8 shifted ownership to the purchaser's broker, or, more commonly, to the organizations holding securities in trust for brokers, bankers, and other financial institutions, the most popular of which in the United States is the Depository Trust Company (DTC).

The DTC is owned by the Depository Trust and Clearing Corporation (DTCC), which is, in turn, owned by the participants of its various subsidiaries, including the DTC. DTCC's participants are primarily banks, brokers, and other financial institutions. The DTC holds 1.4 million securities valued at $87.1 trillion, making it one of the most important financial institutions in the world today.[12]

The DTC holds securities in pools, rather than registering each security to a specific purchaser. By allowing ownership to shift to large financial institutions, especially the DTC, and permitting securities to be pooled together, the UCC and federal government have empowered brokers and other institutions to use other people's investments in a variety of financial arrangements, including short sales, that otherwise would not be possible or difficult if the original purchasers maintained ownership of their investments. However, it is also worth noting that transferring ownership from individuals has increased efficiency and reduced the costs of securities transactions, because most transfers now occur in DTC ledgers only. Securities typically do not need to be moved outside of DTC accounts.

Additionally, the changes to UCC Article 8 have helped to guarantee that the protected creditors of securities intermediaries are given priority ownership to security entitlements when intermediaries, such as popular stockbrokers, use customer assets as collateral. What this means is that if an individual investor's broker were to go bankrupt, the broker's secured creditors—large financial institutions—would be given priority over individual investors who made the mistake of thinking that the security they bought and paid for belongs to them. In such a situation, Article 8 ensures that the investor would become an unsecured creditor, with the investor's claims to their securities falling at the back of the line in an insolvency proceeding. That means that in the event of a widescale financial crash, thousands or even millions of investors could lose a significant portion of their assets to secured creditors.

If the financial markets continue to operate without significant trouble, the changes made to Article 8 will likely have little impact for individual investors. However, if there were a large crash in the financial markets, investors' securities could be taken in the aftermath, all to the benefit of too-big-to-fail financial institutions. There is simply nowhere near enough collateral to cover all the debt and other obligations currently spread throughout the financial markets, so the risks to individuals posed by Article 8 are real and dire.

In order to alleviate concerns about investment markets, Congress created the Securities Investor Protection Corporation (SIPC) in 1970.[13] The SIPC acts in a similar fashion as the Federal Deposit Insurance Corporation does for bank deposit accounts. In the event a broker goes bankrupt, the SIPC would, under most situations, bail out investors up to $500,000 in securities and cash, although the limit for cash is $250,000.[14] Although the SIPC was created by Congress, it is not a government program. It is operated and funded by brokers. Unfortunately, it has been vastly underfunded for years and could not come even remotely close to covering investor losses in the event of a widespread market failure. At the end of 2021, the SIPC fund had approximately $4 billion in assets, a tiny fraction of what would be required in a significant crash.[15] For example, Fidelity Investments alone has approximately $12.6 trillion in assets under management.[16]

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A review of the current UCC,[17] contemporaneous writings by law professors,[18] the ULC drafting committee's comments,[19] 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[20] clearly indicate that the threat posed by Article 8 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. 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 2005 change to federal bankruptcy law—JP Morgan Chase was able to freeze Lehman's institutional accounts as collateral for the loans that Lehman could no longer pay.[21]

Allowing massive institutions, many of which are worth more than $100 billion, to have priority over security entitlements belonging to individual investors creates massive distortions in the marketplace and severely violates property rights. But even if this were not the case, an important question for policymakers remains: is a system truly worth saving if it would happily sacrifice individual investors' wealth to save allegedly too-big-to-fail institutions?

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Policy Recommendations

First, legislators could push back against any alterations to state or federal legal codes, including the UCC, which would make it easier to use a CBDC in the future.[22]

Second, legislators could revise the definition of a "deposit account" in state legal codes so that a CBDC could not be used as a "deposit" in state-regulated banks. For more information about this strategy, see our *Tip Sheet* about the Uniform Commercial Code and the definition of money.[23]

Third, state legislators could alter UCC Article 8 to ensure that individual investors have ownership priority in the evet that a securities intermediary goes bankrupt.

Fourth, state legislators could alter UCC Article 8 so that disputes with financial institutions are resolved in the jurisdiction of the individual investor, rather than the state of the broker-dealer, custodian, or clearing corporation. Currently, jurisdiction is based on the location of the applicable financial institution, not the individual investor.

Endnotes

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2 Uniform Law Commission, “Uniform Commercial Code,” uniformlaws.org, accessed September 26, 2023, https://www.uniformlaws.org/acts/ucc

3 For more information on the basics of CBDCs, see: Jack McPherrin, “Central Bank Digital Currency (CBDC): A Basic Primer,” The Heartland Institute, November 2023, https://heartland.org/publications/central-bank-digital-currency-cbdc-a-basic-primer/

4 Atlantic Council, “Central Bank Digital Currency Tracker,” Accessed September 15, 2023, https://www.atlanticcouncil.org/cbdctracker/

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9 Jack McPherrin, “CBDCs: A Basic Primer.”

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18 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,m 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

19 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

20 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

21 It is important to note that no investors actually lost their principal in this instance. Lehman's retail accounts were sold off to a different broker, but Lehman's institutional accounts were frozen by JP Morgan Chase. Ultimately, those institutional accounts were able to be reclaimed because of a rebound in the financial markets, though they had been held for more than five years, based on the new UCC Article 8 changes and the "safe harbor" provisions added to federal bankruptcy code in 2005. For more information, see: United States Bankruptcy Court, Southern District of New York, Lehman Brothers Holdings Inc., et al., Debtors, Report of Anton R. Valukas, Examiner, Volume 5 of 9, March 11, 2010, accessed from Jenner & Block, https://www.jenner.com/en/news-insights/news/lehman-brothers-holdings-inc-chapter-11-proceedings-examiner-s-report; see also: United States Bankruptcy Court, Southern District of New York, Lehman Brothers Holdings Inc., et al., v. JPMorgan Chase Bank, N.A., "Memorandum Decision Granting In Part and Denying In Part Motion to Dismiss by Defendant JPMorgan Chase Bank, N.A.," April 19, 2012, https://www.nysb.uscourts.gov/sites/default/files/opinions/198038_134_opinion.pdf

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