No. 15-1551

In the

United States Court of Appeals for the Fourth Circuit

FOREST CAPITAL, LLC,

Plaintiff-Appellant,

- v. -

BLACKROCK, INC.,

Defendant-Appellee.

On Appeal from the United States District Court
for the District of Maryland at Baltimore (1:14-cv-01530-JFM)

AMICUS CURIAE BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF DEFENDANT-APPELLEE AND IN SUPPORT OF AFFIRMANCE

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT
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(name of party/amicus)

who is amicus, makes the following disclosure:
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1. Is party/amicus a publicly held corporation or other publicly held entity? ☐ YES ☑ NO

2. Does party/amicus have any parent corporations? ☐ YES ☑ NO
If yes, identify all parent corporations, including all generations of parent corporations:

3. Is 10% or more of the stock of a party/amicus owned by a publicly held corporation or other publicly held entity? ☐ YES ☑ NO
If yes, identify all such owners:

4. Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation (Local Rule 26.1(b))? ☐ YES ☑ NO
If yes, identify entity and nature of interest:

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If yes, identify any publicly held member whose stock or equity value could be affected substantially by the outcome of the proceeding or whose claims the trade association is pursuing in a representative capacity, or state that there is no such member:

6. Does this case arise out of a bankruptcy proceeding? ☐ YES ☑ NO
If yes, identify any trustee and the members of any creditors' committee:

Signature: /s/ Lewis J. Liman Date: Sept. 21, 2015

Counsel for: Securities Industry and Financial Markets Association

CERTIFICATE OF SERVICE

****

I certify that on Sept. 21, 2015 the foregoing document was served on all parties or their counsel of record through the CM/ECF system if they are registered users or, if they are not, by serving a true and correct copy at the addresses listed below:

/s/ Lewis J. Liman
(signature)

Sept. 21, 2015
(date)

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STATEMENT OF IDENTITY, INTEREST, AND AUTHORITY

The Securities Industry and Financial Markets Association ("SIFMA") is a trade association whose mission is to support a strong financial industry, investor opportunities, capital formation, job creation, and economic growth. It is comprised of hundreds of member broker-dealers, banks, and asset managers serving retail clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients.[1] As such, it has an interest in the safe and efficient functioning of the securities markets. SIFMA also has an interest in upholding agreements negotiated by market participants. Those interests are served by applying a coherent set of rules that is specifically designed to expedite the clearance and settlement of securities trades and to provide securities custodians and their customers with the flexibility to structure their relationships through private agreement. They are also served by clear rules that identify those to whom securities custodians owe duties and spell out the conditions under which securities custodians complying with their customers'

[1] SIFMA brings together the shared interests of hundreds of broker-dealers, banks, and asset managers. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. SIFMA regularly files amicus curiae briefs in cases that raise legal issues of particular importance to the participants in the securities industry. For more information, visit www.sifma.org.

instructions may incur liability to third parties with claims to their customers' property.[2]

SIFMA has an interest in this case and an amicus brief is desirable because the position taken by plaintiff-appellant and its amicus—that by maintaining an account for customers, including the obligation to remit funds to customers, a securities custodian takes on the obligations of an "account debtor" under Section 9-406 of the Uniform Commercial Code (the "UCC")—has troubling implications for the legal framework set out in Article 8 of the UCC. The framework is intended to make clear that a securities custodian has specified duties only to its customers and does not take on duties—without its consent—to persons other than its customers. Plaintiff-appellant's position, if adopted, would overturn the legal framework that has been constructed upon which the securities markets and the members of SIFMA rely. It would permit complete strangers to unilaterally impose duties upon securities custodians to redirect to them funds destined to the custodians' customers merely by providing notification of an assignment by the customers. It would place conflicting obligations on securities custodians and burden them with the risk of liability to their customers or third parties for guessing wrongly about which of them has the superior claim. Finally,

[2] SIFMA hereby certifies that no counsel for a party authored this brief in whole or in part, that no party or counsel for a party contributed money that was intended to fund preparation or submission of this brief, and that no person other than the amicus curiae, its members, and its counsel, contributed money that was intended to fund preparation or submission of this brief. BlackRock, Inc. is a SIFMA member.

it would accentuate the risks of financial crisis by impairing liquidity in times of stress to the ultimate detriment not only of the financial system but the economy as a whole.

SIFMA takes no position on any of the factual allegations here. SIFMA does, however, strongly believe that adoption of the rule proposed by plaintiff-appellant and its amicus would undermine well-established principles of law upon which market participants rely and would disrupt the free flow of securities that is critical to the functioning of our financial system.

PRELIMINARY STATEMENT

The investment managers, banks, brokers, and other agents that act as custodians of securities for investors are subject to a logical and easily administered legal framework specifically designed to enable the securities markets to function. The fundamental principles at the heart of that framework are as follows: (i) securities custodians are free to structure their relationships through private agreement; (ii) the custodians must follow their customers' instructions in accordance with the agreements between them and their customers and any third parties; and (iii) the custodians can act in reliance on those instructions with the certainty that doing so will not subject them to liability to entities with which they have no agreements.

The rule proposed by plaintiff-appellant and its amicus would

overturn that legal framework and go against its basic principles. Under that rule, based on the obligation of a securities custodian to return funds to its customer, a purported assignee of the customer can—merely by providing "notification" to the securities custodian without obtaining its consent—unilaterally create a promise by the custodian to pay its customer's funds to the purported assignee that would trump the custodian's duty to return the funds to its customer or to follow its customer's instructions. That rule is illogical and would cause uncertainty, delay, confusion, inefficiency, and risk in a market that depends so much on certainty, speed, clarity, efficiency, and safety.

Plaintiff-appellant and its amicus improperly seek to substitute a rule that applies in the entirely different context of debtor-creditor relationships for the carefully considered commercial law framework for investment property. Their position lacks textual support and is directly contrary to the objectives of the UCC's framers, and if accepted would destabilize our securities markets.

STATEMENT OF FACTS

BlackRock, Inc. ("BlackRock") served as the securities intermediary for a securities account held by its customer People's Power & Gas LLC ("PP&G"). JA-73–76. PP&G granted a security interest in the securities account to ISO New England Inc. ("NEISO"), a company that provided periodic extensions of credit to PP&G. JA-73, 76 § 3(b). PP&G was required to post funds to NEISO

to secure NEISO's extensions of credit to it. JA-73. NEISO negotiated and entered into a control agreement with a BlackRock subsidiary and PP&G on April 26, 2011 (the "Control Agreement").[3] JA-73–85. Pursuant to the Control Agreement, BlackRock and PP&G agreed to provide NEISO certain rights in the securities account, including NEISO's right to deliver entitlement orders to BlackRock with which BlackRock was obligated to comply "without further consent" by PP&G or any other person. JA-78 § 10.

On December 24, 2013, PP&G sent BlackRock a letter stating that, pursuant to certain financing agreements entered into between PP&G and another entity, Forest Capital, LLC ("Forest"), PP&G had granted Forest a security interest in substantially all of its assets. JA-48. The letter purported to "serve as notification and authorization" that BlackRock was "to remit to Forest all monies that may be or may become payable by BlackRock" to PP&G. *Id.* The letter stated that the "instruction cannot be changed except by a writing duly executed by Forest." *Id.* Pursuant to PP&G's instructions, BlackRock made one remittance of funds to Forest. *See* JA-433–35. BlackRock subsequently made two remittances of funds to PP&G pursuant to PP&G's instructions. JA-51–52, JA-230 ¶¶ 31-32.

Forest was not a party to the Control Agreement or any other control agreement with BlackRock relating to the securities account. It never negotiated or

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[3] A control agreement is a common tool for "perfecting" a security interest in investment property. *See* Md. Code Ann., Com. Law §§ 9-106, 8-106 (LexisNexis 2013).

entered into any agreement with BlackRock and had no relationship with BlackRock. BlackRock never undertook any duties to Forest, and never agreed to comply with the purported instruction in the December 24, 2013 letter.

ARGUMENT

I. BLACKROCK HAD NO DUTY TO FOREST UNDER THE UCC.

A. Securities Intermediaries and Investment Property Are Subject to a Specialized Legal Framework Under Article 8.

The argument put forward by Forest and its amicus Commercial Finance Association ("CFA") is based on a fundamental misunderstanding of the role of securities intermediaries and the nature of investment property as they function in the modern economy. They argue that BlackRock, as a custodian of investment property belonging to its customer PP&G, became obligated and took on obligations to PP&G's assignee—Forest—without BlackRock's consent because it supposedly received notice that amounts due to PP&G had been assigned to Forest. Its syllogism (faulty as it may be) is something as follows: (i) UCC Section 9-406 provides that an "account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee"; (ii) BlackRock was an "account debtor" because—while the property it held was "investment property" excluded

from the operation of UCC 9-406—it had a separate and independent "monetary obligation to PP&G when funds bec[a]me available" to release them to PP&G at PP&G's and NEISO's direction and thus funds that PP&G "became entitled to receive" were a "payment intangible," regardless of the source of the underlying funds to be paid; and (iii) BlackRock had received "notification" that PP&G had assigned the right to those funds to Forest and thus undertook an independent obligation not to follow PP&G's directive to return the funds to PP&G but rather to send the funds to Forest pursuant to the "notification." Appellant's Br. at 17-18, 21. *See also* Amicus Br. at 12 ("BlackRock was obligated as the 'account debtor' on the payment intangible owing to PP&G because it held the funds and was subject to the nondiscretionary directives.").

Through those means, Forest is attempting to bypass a claim in bankruptcy against PP&G and to jump ahead of all of PP&G's other creditors. Forest's claim is as radical and wrongheaded as it is novel. Its argument is wrong with respect to all forms of investment property. Under that argument, a custodian of investment property, including a custodian of a securities account, could be held liable to a party it has no relationship with for following its customer's instructions. In essence, Forest claims that based on BlackRock's obligation to return funds to PP&G, BlackRock—and presumably every other securities intermediary similarly situated—also assumed a non-contractual obligation to pay

Forest, regardless of the terms of the underlying agreement between BlackRock and PP&G. Under Forest's argument, merely by notifying the securities intermediary—without obtaining such intermediary's consent—a complete stranger can unilaterally create a separate obligation by the securities intermediary to pay it that would trump the intermediary's duty to channel payments from a securities account to its customer or to follow its customer's instructions. That argument fundamentally misunderstands Articles 8 and 9 of the UCC. If accepted, it would undermine well-established principles of law and throw a wrench into the free flow of securities that is critical to the functioning of our financial system.

Forest and its amicus do not dispute that the account held by BlackRock on PP&G's behalf was "investment property" under the UCC. *See* Md. Code Ann., Com. Law § 9-102(a)(49) (LexisNexis 2013) (defining investment property as "a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account").[4] Nor could they. The Control Agreement states on its face that "the Account is a 'securities account' as defined in Section 8-501 of the UCC." JA-76 § 2(b). They also do not dispute

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[4] A "securities account" is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." *Id.* § 8-501(a). A "securities intermediary" is a clearing corporation or a "person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." *Id.* § 8-102(a)(14). An "entitlement holder" is "a person identified in the records of a securities intermediary as the person having a security entitlement" against it. *Id.* § 8-102(a)(7). In turn, a "security entitlement" refers to "rights and property interest" with respect to a securities account. *Id.* § 8-102(a)(17).

that BlackRock was a securities intermediary. The Control Agreement defines the "Securities Intermediary" as "BlackRock Institutional Management Corporation, as agent for BlackRock Liquidity Funds and BlackRock Funds . . . acting in its capacity as a 'securities intermediary' as defined in Section 8-102(a)(14) of the UCC." JA-75. And, finally, Forest and its amicus do not dispute that as a securities intermediary holding investment property BlackRock was subject to a distinctive set of rules under Article 8 of the UCC, other statutes and regulations, and private agreement that reflect the distinctive characteristics of such property and the distinctive role they play in the functioning of the financial system.

Those rules make clear that a securities intermediary who holds investment property has specified duties only to the intermediary's customer and does not take on duties—without its consent—to persons other than its customer. Com. Law §§ 8-501, 8-504–8-508. *See id.* § 8-501 cmt. 1 ("A securities account is a consensual arrangement in which the intermediary undertakes to treat the customer as entitled to exercise the rights that comprise the financial asset.").

Under those rules, a securities intermediary takes on the obligation to "exercise rights with respect to a financial asset if directed to do so by an entitlement holder." *Id.* § 8-506. The UCC provides that a "securities intermediary satisfies the duty if: (1) [t]he securities intermediary acts with respect to the duty as agreed upon by the entitlement holder and the securities

intermediary." *Id.* In addition, a securities intermediary is obligated to comply with an entitlement order (*i.e.*, "a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement"). *Id.* § 8-507(a); *id.* § 8-102(a)(8). Under this provision, "[a] securities intermediary satisfies the duty if: (1) [t]he securities intermediary acts with respect to the duty as agreed upon by the entitlement holder and the securities intermediary." *Id.* § 8-507(a). *See also id.* § 8-505(b) (an intermediary has an obligation to remit to its customer any payment or distribution by an issuer that it receives). Finally, pursuant to Section 8-115, a securities intermediary is not liable to a third party for acting on its customer's instructions except in the limited circumstances where it did so *after it was served with legal process* issued by a court with jurisdiction enjoining such action or where it colluded with its customer to violate the third party's rights. *Id.* § 8-115; *see also id.* cmt. 3 (this rule "applies even though the securities intermediary, or the broker or other agent or bailee, had notice or knowledge that another person asserts a claim to the securities").

Under those provisions, a secured creditor may obtain an interest in a customer's security entitlement and a right to have its entitlement orders complied with, but only with the consent of the securities intermediary. Thus, in particular, UCC Section 8-106(d) provides that "[a] purchaser has 'control' of a security

entitlement if: (1) [t]he purchaser becomes the entitlement holder; [or] (2) [t]he securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder."[5] *Id.* § 8-106(d). And UCC Section 8-507 provides that "[a] securities intermediary satisfies the duty" to comply with an entitlement order if it "acts with respect to the duty as agreed upon by the entitlement holder and the securities intermediary." *Id.* § 8-507(a). The import of those rules is that, in order for a securities intermediary to have duties to comply with an entitlement order from anyone other than the holder of the entitlement, the securities intermediary and the entitlement holder must both consent. This is consistent with other restrictions on actions of custodians that hold investment property. *Id.* § 8-106(g)(1) ("An issuer or a securities intermediary *may not* enter into an agreement of the kind described in subsection (c)(2) or (d)(2) of this section without the consent of the registered owner or entitlement holder, but an issuer or a securities intermediary *is not required* to enter into such an agreement even though the registered owner or entitlement holder so directs.") (emphases added). In the absence of consent by the affected parties—including the securities intermediary—mere notice is insufficient.

[5] A secured creditor is considered a "purchaser." *Id.* § 1-201(b)(29) ("'Purchase' means taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property."); *id.* § 1-201(b)(30) ("'Purchaser' means a person that takes by purchase."). A purchaser also may obtain control if another person has control on behalf of the purchaser. That provision is not relevant here because there is no allegation that any person had control on behalf of Forest.

This is precisely the arrangement NEISO obtained in this case—and what other third parties seeking to impose duties on securities intermediaries do in every case. Seeking to ensure that it would receive the benefits of the UCC, it obtained the consent of both BlackRock and of PP&G by entering into a so-called control agreement with them. JA-73–85. The Control Agreement contained the agreement of both BlackRock and of PP&G that BlackRock would honor entitlement orders by NEISO "without further consent" by PP&G or any other party. JA-78 § 10.

Conspicuously, in its appeal Forest does not claim that it has an interest in PP&G's account with BlackRock or that BlackRock had a duty under Section 8-507 to comply with an entitlement order by Forest. Had it wanted that right, it could have bargained for it with both BlackRock and with PP&G.

B. Forest Cannot Bypass the Rules of Article 8 by Contending That the Obligation to Return Funds to PP&G Constitutes a Payment Intangible.

Forest nonetheless seeks to bypass the provisions of Article 8 with respect to investment property by arguing that—by maintaining an account for PP&G, including the obligation to return funds to PP&G—BlackRock took on the obligations of an "account debtor" under UCC Section 9-406. It and its amicus argue that BlackRock became subject to Section 9-406, and Forest became entitled to payment directly from BlackRock (in the absence of BlackRock's consent),

because BlackRock had a separate and independent "monetary obligation to PP&G when funds bec[a]me available" to release them to PP&G at PP&G's and NEISO's direction and thus funds that PP&G "became entitled to receive" were a "payment intangible." Appellant's Br. at 17-18, 21. According to Forest's amicus, "BlackRock was obligated as the 'account debtor' on the payment intangible owing to PP&G because it held the funds and was subject to the nondiscretionary directives." Amicus Br. at 12.

This argument misunderstands both Section 9-406 and the relationship that custodians such as BlackRock enjoy with the customers for whom they provide custodial services. Section 9-406 is applicable to "account debtor[s] on an account, chattel paper, or a payment intangible." Com. Law § 9-406(a). It provides that "an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee." *Id.* Under this provision, then, the payment by an account debtor to the assignor—after notice of an assignment—is not sufficient to discharge the account debtor's obligation to the assignor. In that circumstance, the account debtor still does not take on an independent obligation to

the assignee (that would have to be done by contract);[6] rather, the assignee becomes subrogated to the claim of the assignor against the account debtor.

Section 9-406 is not applicable to a situation such as that here for a number of reasons. A securities intermediary serves as a custodian, and has an agency relationship with its customer.[7] The relationship between a custodian and its customer such as that here simply cannot be understood as a debtor-creditor relationship of the sort envisioned by Section 9-406. In the typical custodian-customer relationship, the custodian does not have an independent payment obligation as required by Section 9-406. The custodian is not borrowing the funds it holds for its own use or purchasing a product on credit. Its obligation to return funds to the customer is akin to the obligations of payment agents the courts have routinely held are not account debtors under Section 9-406. *See Nationwide Transp. Fin. v. Cass Info. Sys., Inc.*, 523 F.3d 1051, 1061 (9th Cir. 2008) ("nothing in § 9-406 imposes the account debtor's obligations on its agents"); *Bamberger Polymers Int'l Corp. v. Citibank*, 124 Misc.2d 653, 656 (N.Y. Sup. Ct. 1983) (a

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[6] SIFMA reiterates the argument set forth in BlackRock's brief that Forest's argument fails also because Section 9-406 does not provide an independent right of action by an assignee against an account debtor.

[7] In that capacity, securities intermediaries are subject to a number of restrictions. *See, e.g.*, Com. Law § 8-504(a) ("A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements the securities intermediary has established in favor of its entitlement holders with respect to that financial asset."); 17 C.F.R. § 240.15c3-3(b)(1) (2015) ("A broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers."); 15 U.S.C. § 78o(e) (2014) ("Every registered broker or dealer shall provide notice to its customers that they may elect not to allow their fully paid securities to be used in connection with short sales.").

bank that was "merely the agency moving funds at the direction of" another party could not be considered an "account debtor").

As important, however, is that "investment property" does not fall within any of the three types of property covered by Section 9-406, which are: "accounts," "chattel paper," and "payment intangibles." It is specifically excluded from the definition of "account." Com. Law § 9-102(a)(2) (account "does not include . . . investment property"). It is not included in the definition of "chattel paper," which includes only records evidencing both a monetary obligation and a security interest in specific goods. *Id.* § 9-102(a)(11). And it is excluded from the definition of "general intangibles," of which "payment intangibles" are a subset. *Id.* § 9-102(a)(42) ("general intangible means any personal property . . . other than . . . investment property"); *id.* § 9-102(a)(62) ("'payment intangible' means a general intangible under which the account debtor's principal obligation is a monetary obligation"). Thus, the UCC's drafters did not intend for the rights and obligations set forth in Section 9-406 to apply to "investment property." *Cf. id.* § 9-102 cmt. 5.d. (noting that "[o]ne important consequence" of the exclusion of commercial tort claims, deposit accounts, and letter-of-credit rights from the revised definition of "general intangible" is that tortfeasors, banks, and persons obligated on letters of credit do not have the rights and obligations set forth in Sections 9-404, 9-405, and 9-406).

The UCC does not, as Forest and its amicus suggest, bifurcate the right to receive payment from investment property (including a securities account) from the investment property to which it is appurtenant. For example, every securities intermediary must follow the instructions of its customer with respect to the assets in the securities account. That is inherent in the notion of a securities account—there must be some agreement for the handling of assets at the direction of the customer. *See id.* § 8-501(a). The obligation also is imposed under Section 8-507 of the UCC. *Id.* § 8-507 cmt. 1 ("the right to have one's orders for disposition of the security entitlement honored is an inherent part of the relationship"). It thus follows that the securities intermediary's obligation to deal with the assets at the direction of the customer cannot constitute an independent "payment intangible" separate and apart from the investment property. If that were so, the specific provisions of Article 8 would be trumped by the more general provisions of Section 9-406. While the securities intermediary's obligations under Sections 8-501 and 8-504 to 8-508 with respect to investment property would be limited to those to the entitlement holder and, with the consent of both the securities intermediary and entitlement holder, to specified third parties, that limitation would in practice be meaningless. A securities intermediary, such as BlackRock, that signed a control agreement with two other parties, such as PP&G and NEISO, would by virtue of that agreement take on potentially conflicting

duties to third parties. But the implications of the argument extend even further. Under Forest's theory, the entitlement holder, with or without a control agreement, by seeking to enjoy use of the investment property and to maintain control over it, would be creating a payment intangible that third parties could unilaterally intercept and divert through mere notice. Forest's theory also would permit creditors to bypass Section 8-112 of the UCC, which prevents a creditor from reaching its debtor's interest in a security entitlement except by legal process. *Id.* § 8-112(c). It is thus not surprising that Article 9 does not classify a right to payment as a type of property separate from the underlying property to which it relates. For example, the rights to payment under a lease cannot be separated from the lease itself. The Official Comment, prepared by the drafters of the most recent revisions to Article 9 of the UCC, states: "If, taken together, the lessor's rights to payment and with respect to the leased goods are evidenced by chattel paper, then, contrary to *In re Commercial Money Center, Inc.*, 350 B.R. 465 (Bankr. App. 9th Cir. 2006), an assignment of the lessor's right to payment constitutes an assignment of the chattel paper." Com. Law § 9-102 cmt. 5.d.[8] *Cf. In re Montreal, Maine & Atl. Ry., Ltd.*, 521 B.R. 703, 713 (B.A.P. 1st Cir. 2014), *aff'd*, No. 15-9003, 2015 WL 4934212 (1st Cir. Aug. 19, 2015) (rejecting creditor's argument that rights to

[8] The Official Comment disagreed with the conclusion of the Bankruptcy Appellate Panel of the Ninth Circuit that payment streams from certain equipment leases that had been stripped from the leases were not chattel paper but instead, payment intangibles. *See In re Commercial Money Ctr., Inc.*, 350 B.R. 465, 480 (B.A.P. 9th Cir. 2006).

payment arising under an insurance policy were "payment intangibles" separate from interests or claims arising under insurance policies, for "[t]his type of oscillation in and out of Article 9's scope could not have been the intention of the drafters of the UCC").

Were it otherwise, under Forest's theory, every securities intermediary would be subject to two independent and potentially conflicting duties with respect to every securities account: a duty under UCC Sections 8-507 and 8-508 to comply with its customer's instructions to transfer security entitlements to an account at another intermediary or to change how the security is held, and a potentially conflicting duty under Section 9-406 to make payments from a securities account to the customer's purported assignee when the securities intermediary has notice of an ostensible assignment by the customer. Indeed, applying different rules to the components of investment property not only would undermine the UCC but also dislocate the operations of the market. Extending Section 9-406 to rights in investment property would cause uncertainty not only about whose instructions a securities intermediary must follow but also which rules apply to the various functions it performs. Simply put, a securities intermediary would never know what to do. And it could face the risk of having to pay its own funds to its customer or to the customer's purported assignee based on a determination that it sent its customer's funds to the wrong party. Under those circumstances, few

rational firms would undertake to serve as custodians for investment property except perhaps for a significant fee. This would hamper investors' ability to hold securities indirectly and in turn would reduce trading in securities given the predominance of indirectly held securities in the modern economy. The firms that continue to provide services as securities custodians would operate less effectively, which would reduce liquidity and destabilize the securities markets in times of stress.

II. FOREST'S ARGUMENT WOULD HAVE RADICAL RESULTS DIRECTLY CONTRARY TO THE OBJECTIVES CONTEMPLATED BY THE FRAMERS OF THE UCC.

Forest's argument would have dramatic and radical consequences never contemplated by the framers of the UCC. Indeed, they are directly contrary to the objectives of the UCC with respect to investment property and security entitlements.

The 1994 amendments to the UCC, which introduced the concepts of "investment property" and "security entitlement," were intended to enhance the liquidity of the securities markets and to establish clear and certain rules for the securities clearance and settlement system, ensure the efficient operation of that system, and expedite the clearance and settlement of securities trades. *See* James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. Rev. 1431, 1433-34 (1996). Those amendments recognized, as this case reflects, the

modern reality that, unlike many other forms of property, property interests in securities are predominantly held indirectly. Although in some instances an investor may hold a security directly, for the most part investors hold securities indirectly by depositing them with one in a chain of securities intermediaries who act as custodians.[9] This is known as the indirect holding system. That system has developed to accommodate the increase in the volume of securities traded by dispensing with the need for buyers and sellers of securities to deliver physical certificates back and forth each time a security is traded.

A core tenet of the legal framework for investment property is that securities intermediaries can structure their relationships through private order and—in the absence of contractual agreement otherwise—are free to answer to the entitlement orders of their customers without fear that doing so will subject them to liability to third parties. That notion is a core principle of UCC Section 8-501. *See* Com. Law § 8-501 cmt. 5 ("the nature of a security entitlement is that the intermediary is undertaking duties only to the person identified as the entitlement holder"); *see also id.* § 8-507 cmt. 3 ("One of the basic principles of the indirect holding system is that securities intermediaries owe duties only to their own customers."). It is also the principle behind Section 8-115. Section 8-115 reflects

[9] Over 90% of publicly issued securities in the United States are estimated to be held at and distributed through the Depository Trust Company, the world's largest securities depository and a clearing agency for the settlement of securities trading. The Depository Trust Company, *Disclosure under the Principles for Financial Market Infrastructures*, 8, 66 (2014).

a policy determination that a securities intermediary "should not be placed in the position of having to make a legal judgment about the validity of [an adverse] claim at the risk of liability either to its customer or to the third party for guessing wrong," *even where it has notice of the claim*. *Id.* § 8-115 cmt. 3.

These rules are central to the functioning of the marketplace. In our fast-paced and high-volume securities markets, securities intermediaries must be able to act on their customers' instructions instantaneously. Huge volumes of assets are held as investment property, including securities accounts. Every day, literally hundreds of billions of dollars of those assets exchange hands through the Depository Trust Company.[10] The liquidity of the system is essential to ensuring the efficient functioning of our capital markets and that assets flow immediately to their most efficient uses. In our modern economy, businesses do not hold their assets as cash under the mattress. They hold many assets as investment property, and require the immediate availability of that property to continue operating. The liquidity of investment property is essential to the ability of debtors to pay their debts as they come due. And it is essential to the use and the value of that property to secure debtors' obligations to third parties. Few third parties will accept such property as collateral—at least with the value that is currently placed on it—if their

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[10] The Depository Trust Company, *Settlement & Asset Services*, http://dtcc.com/asset-services.aspx (last visited Sept. 14, 2015).

rights are insecure. And, few securities intermediaries will agree to accept investment property if their obligations are unclear.

The genius of the modern UCC is its creation of clear and easily administered rules applicable to securities intermediaries, the holders of investment property, and their creditors. With rare exceptions not relevant here, a securities intermediary is liable only to the entitlement holder or to those to whom the securities intermediary agrees with the entitlement holder the securities intermediary will owe duties. It can control its obligations and ensure its ability to discharge them by agreeing in advance as to what those obligations will be and accepting an obligation only if it can be easily and inexpensively honored. And a third party creditor can protect itself—as NEISO (but not Forest) did so here—by agreeing in advance through a control agreement with the securities intermediary what obligations the securities intermediary will undertake and how those obligations will be discharged (and at what cost).

Applying the Section 9-406 rule for account debtors to investment property would have chaotic results and would undermine all of those objectives to the detriment of the financial system and, ultimately, to the functioning of our economy as a whole. It would rewrite the law and change the bargains already made between securities custodians and their customers, as illustrated by this

case.[11] For one, the new regime would burden intermediaries with the risk of liability to their customers or third parties whenever they are caught in the middle of conflicting claims. It also would impose obligations that intermediaries never agreed to undertake. And most importantly, the securities markets would operate less quickly and efficiently if the law were rewritten as Forest urges. A function that the law previously treated as routine and ministerial, which securities intermediaries performed quickly through mechanisms established in advance, would become a laborious and time-consuming activity involving frequent investigations and assessments. Notices from purported assignees would increase. The performance of securities intermediaries' traditional functions would be delayed by the recurrent need to make judgments under Section 9-406 about whether a notification "reasonably identif[ies] the rights assigned," whether to request "reasonable proof" that an assignment has been made, and whether a purported assignee has provided such proof. Com. Law § 9-406(b), (c). It would be impracticable for securities intermediaries to perform this detailed investigation and legal assessment given the number of accounts and volume of transactions they manage. This process would increase the administrative costs of securities intermediaries and in turn increase the fees charged to investors. Disruptions to the activity of securities intermediaries would reduce liquidity and spread the risks of

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[11] In response to BlackRock's statement that the Control Agreement exempted it from liability and gave it the right to indemnification by Forest as PP&G's alleged assignee, Forest asserts that it is not a party to the Control Agreement and has no obligations pursuant to it. Appellant's Br. at 41 n.8.

defaults throughout the financial system. The application of Section 9-406 thus would undermine the objectives of the UCC's drafters, who sought to avoid precisely that outcome. *See id.* § 9-328 cmt. 8 ("One of the circumstances that led to the revision was the concern that uncertainty in the application of the rules on secured transactions involving securities and other financial assets could contribute to systemic risk by impairing the ability of financial institutions to provide liquidity to the markets in times of stress.").

Contrary to Forest and its amicus CFA's assertions, applying the rule in Section 9-406 to investment property would be detrimental to secured creditors as well. If Section 9-406 were held to apply based on the existence of control agreements, securities intermediaries would be less willing to enter into such agreements, significantly limiting the use of investment property and burdening the use of one of the principal methods for perfecting a security interest in indirectly-held securities.

And, finally, it is unnecessary. For a party in Forest's position that desires to protect its interests has a secure and easy way to do so already provided for by the UCC. It can negotiate with its debtor and with the debtor's securities intermediary.

CONCLUSION

For the foregoing reasons, SIFMA respectfully submits that the Court should affirm the district court's order below.

Dated: September 21, 2015
New York, New York

Respectfully submitted,

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 15-1551 **Caption:** Forest Capital, LLC v. BlackRock, Inc.

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