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Potential Impact of UCC Article 12 on Fund Finance Transactions

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At the bottom of the stack in investment fund structures, there are generally "real" assets—things like equity interests in portfolio companies, mortgage loans, commercial receivables, maybe even bricks and mortar. Fund finance transactions, though, are by design crafted to be at several levels removed from such underlying assets. With such ultimate assets remote from the transaction, it may seem to fund finance practitioners that concerns about changes in the Uniform Commercial Code ("UCC") relating to the nature of collateral assets are just as remote.

The 2022 Amendments to the UCC (the "2022 Amendments")[1] and new Article 12, however, could have substantial effects on fund finance transactions precisely because they can affect the types of digital and electronic intangible assets that stand as direct collateral in fund finance structures.

The 2022 Amendments were envisaged as a means to provide a legal groundwork for commercial and financing transactions in digital assets not adequately covered by existing law. Blockchain-based cryptocurrency clearly was the drafters' paradigm case in crafting the provisions.[2] The 2022 Amendments, as they emerged from the drafting committees, covered far more than just crypto. And with digitization and other technological changes increasingly affecting both fund finance and the financial markets generally, it is timely to look at the risks posed and opportunities offered by the 2022 Amendments.

Most fund finance structures are supported by (i) the subscription obligations of the investors to the fund obligor, in a subscription finance facility, or (ii) assets of the fund obligor, including equity interests (and related rights) in downstream fund entities in a NAV facility. While there may have been a time when such subscription rights, equity interests and other assets would have been embodied solely in tangible paper documents, it is likely today that they would take various electronic or digital forms. Indeed, even beyond now-routine electronic processes like pdf email distributions, DocuSign signatures and internet document portals, it is increasingly common to read of funds establishing subscription contracts and fund formation processes on distributed ledgers and using tokenized digital solutions.[3] Such electronic assets are the subject matter of the 2022 Amendments.

To understand how the 2022 Amendments could affect fund finance transactions, one needs to understand the changes they make. The new concept of controllable electronic records ("CERs") is the key innovation. CERs are a type of electronic record that can be subjected to "control" as defined in the new statute.[4] The draftsmen of the 2022 Amendments appear in particular to have had in mind controllable electronic records with intrinsic value in the records themselves (such as crypto coins). However, the 2022 Amendments also encompass certain contractual payment rights evidenced by CERs and under which the account debtor undertakes to pay the person in control of the CER—payment rights known as controllable accounts ("CAs") and controllable payment intangibles ("CPIs").[5]

What is most critical about CERs, CAs and CPIs is that the 2022 Amendments imbue them with two new and unique characteristics: (i) a "take-free" right,[6] and (ii) the ability to perfect security interests by control, with priority over other methods of perfection.[7]

The take-free right provides, in substance, that a person who obtains control of a CER for value, in good faith and without notice of a claim of a property right in the CER (i.e., what Article 12 terms a "qualifying purchaser"[8]), takes the CER free of a competing property right in the CER. Further, such take-free right extends to a CA or CPI that is evidenced by such a CER; a qualifying purchaser of such a receivable takes free of a competing property right to that CA or CPI as well.

Further, the 2022 Amendments permit security interests in CERs—and CAs and CPIs evidenced by them—to be perfected by control, and such control perfection to have a higher priority than that afforded by the filing of a UCC financing statement. Under the pre-2022 Amendment UCC, security interests in general intangibles (the category into which CERs would fall), accounts and payment intangibles as original collateral are perfected only by filing. While it still works to perfect by filing against CERs, CAs and CPIs after the 2022 Amendments, the priority of a secured party with control beats that of a secured party which only files.

When you map these Article 12 innovations onto an investment fund structure that has digitized or tokenized certain of its processes, it is not hard to see how they may offer advantages in a fund finance transaction. For example, consider a fund which has established a digital subscription protocol where investors' subscription obligations are represented by digital tokens, which can be moved from the fund's wallet to a secured party's wallet. Further, assume that the subscription token operates by moving funds (perhaps in the form of a stablecoin[9]) from the investor to the fund (or another person in control of the token) automatically upon the execution of a smart contract protocol.

Assuming that such a subscription token were to otherwise satisfy the definitions of CER and CPI, a fund finance lender who takes control of the token as collateral would have *better* collateral than it would have over a traditional, non-Article 12 subscription obligation. The fund finance lender could "take free" of any third party property claims to the token if the lender could qualify as a qualifying purchaser. Further, the fund finance lender could get a higher-priority security interest through perfecting by control—even priming a security interest perfected by a pre-existing financing statement covering the token.

A similar result could be envisaged for equity interest collateral supporting NAV facilities. Here, one might posit a digitized or tokenized fund structure in which the equity interests of the fund in a subsidiary are CERs or CPIs.

If NAV collateral, even if digitized or tokenized, took the form of interests in a traditional legal entity (such as a corporation, LLC or LP), then it is very likely that Article 12 would not apply. The reason is that the drafters of the 2022 Amendments tried to be careful not to disrupt existing business and legal processes; rather, they wished to fill in gaps where legal structure was missing for digital assets. Accordingly, the 2022 Amendments exclude from the scope of CERs a number of existing UCC asset types, including "investment property" (defined in the UCC to include, among other things, securities, securities accounts and security entitlements). [10] If a digitized vehicle does not take the form of such a traditional entity, however, then what exactly is it, and how would its equity interests be characterized under the UCC?

One potential option for such a digitized vehicle that has emerged from the blockchain ecosystem is the decentralized autonomous organization ("DAO"). DAOs are not new. Numerous investment DAOs have been established to pool resources of member to invest in a range of assets. In exchange for their investments, the investors in such a DAO would typically receive governance tokens—assets which may be characterized as CERs under Article 12.

However, a DAO in and of itself doesn't imply a legal structure; the DAO at its basic concept is just software.[11] Whether, and what kind of, an entity is created thereby can vary. A DAO without attributes of a traditional legal structure (such as limited liability) may not achieve the business needs of the relevant fund structure.

Several states have supplemented their limited liability company statutes to provide for LLCs that are designated as DAOs and including provisions intended to facilitate their operation as DAOs, such as explicitly permitting management by smart contract.[12] If a DAO is organized under state law (such as Wyoming's) that permits it to be treated as a species of LLC, the UCC characterization of ownership interests in such a DAO would presumably follow the usual analysis for an LLC interest. Depending on the state law, it may be possible to "opt in" to Article 8[13] to cause membership interests to be deemed securities under the UCC. In such a case, NAV collateral comprised of those membership interests, even if tokenized, would fall outside the definition of CER.

But what about DAOs set up otherwise? What if the DAO is an LLC under its state statute but does *not* opt into Article 8, or what if the DAO is organized under the law of a state that does not provide for a clear legal entity treatment? In UCC terms, characterization of the ownership interests in such a DAO would likely follow the characterization of the kind of organization that the DAO *is* deemed to create, even if it turns out to create a general partnership or other unincorporated association.[14] If such digitized or tokenized interests are not securities, then they would not be excluded from the CER definition, and it is possible that they could fall within the ambit of Article 12. In that case, a NAV lender looking at such DAO interests as collateral could get similar "take free" and control perfection advantages as discussed above.

Further, it is not necessarily obvious whether the smart contracts themselves which execute transactions and undertake governance in DAOs would be considered part of the ownership interest in the DAO, or would be something separate—just a contract that happens to be expressed in code rather than words, for example. In any case, smart contacts may constitute an important element of collateral in a NAV facility whether they embody ownership and governance rights, or have other functions. A NAV lender seeking to take a security interest in such a smart contract may even have a more direct argument the such a non-ownership or

non-governance smart contract could fall within the CER definition and thereby obtain a superior Article 12 collateral interest.

Finally, note that the 2022 Amendments are not solely the province of blockchain and tokenized interests. Nowhere in the text of the 2022 Amendments does the statute mention “blockchain”, “distributed ledger”, “token” or the like. The UCC as amended by the 2022 Amendments only looks to whether an asset is “electronic”, which itself is defined in a broad way.[15] Such interests and intangible rights would not have to be tokenized or reside on a blockchain in order for an Article 12 analysis to be appropriate, as long as they are electronic.

As the 2022 Amendments are more widely adopted, participants in the fund finance markets will need to work with their lawyers and technology experts to understand the impacts of Article 12 on their finance transactions, both from an offensive and defensive perspective. Those participants which are able to take advantage of the attributes of these new Article 12 asset types may find themselves with a leg up—and those that fail to keep a defensive eye on Article 12 may find themselves at a disadvantage.

[1] Uniform Commercial Code Amendments (2022) (Uniform Law Comm’n, in partnership with American Law Institute, 2022). For purposes of this article, “UCC (Amended)” refers to the Uniform Commercial Code as amended by the 2022 Amendments.

[2] For a more in-depth description of the 2022 Amendments, *see* C. McDermott, M. Stempler, “New UCC Article 12 Matters to More than Just Cryptocurrency,” The National Law Review, March 31, 2023. **https://natlawreview.com/article/new-ucc-article-12-matters-to-more-just-cryptocurrency**

[3] For example, Blackrock has recently rolled out a tokenized Treasury market fund, which it created with “real world assets” (RWA) tokenization services platform Securitize. Untangled Finance, another RWA tokenization platform, recently announced a USDC private credit pool. *See* **https://www.coindesk.com/markets/2024/04/30/blackrocks-buidl-becomes-largest-tokenized-treasury-fund-hitting-375m-toppling-franklin-templetons/** (accessed 5/9/2024); **https://www.coindesk.com/business/2024/05/02/tokenized-private-credit-platform-untangled-opens-its-first-usdc-lending-pool-on-celo/**

[4] ““Controllable electronic record” means a record stored in an electronic medium that can be subjected to control under Section 12-105. ...” UCC (Amended) Section 12-102(a)(1).

[5] ““Controllable account” means an account evidenced by a controllable electronic record that provides that the account debtor undertakes to pay the person that has control under Section 12-105 of the controllable electronic record.” UCC (Amended) 9-102(a)(27A).

““Controllable payment intangible” means a payment intangible evidenced by a controllable electronic record that provides that the account debtor undertakes to pay the person that has control under Section 12-105 of the controllable electronic record.” UCC (Amended) 9-102(a)(27B).

[6] See UCC (Amended) Section 12-104(e).

[7] See UCC (Amended) Sections 9-314, 9-326A.

[8] ""Qualifying purchaser" means a purchaser of a controllable electronic record or an interest in a controllable electronic record that obtains control of the controllable electronic record for value, in good faith, and without notice of a claim of a property right in the controllable electronic record." UCC (Amended) 12-102(a)(2). Note that under the UCC, the term "purchaser" encompasses not only an outright buyer, but also a person who takes a security interest. UCC (Amended) Section 1-201(a)(29), (30).

[9] Note that a range of other types of "on-chain money" can be envisaged and are subject to serious discussion, from digital currencies to tokenized bank deposits. These solutions each pose their own UCC and regulatory questions, which are not considered in this article.

[10] ""Controllable electronic record" ... does not include a controllable account, a controllable payment intangible, a deposit account, an electronic copy of a record evidencing chattel paper, an electronic document of title, electronic money, investment property, or a transferable record." *See* UCC (Amended) Section 12-102(a)(1).

[11] "A DAO is an unincorporated business organization that operates on blockchain software and is run directly by those who have invested in it (the "contributors" or "members"). It is essentially an internet community with a shared purpose and the equivalent of a shared online bank account." Gail Weinstein, Steven Lofchie, Jason Schwartz, A Primer on DAOs, *Harvard Law School Forum on Corporate Governance* (posted Sept. 17, 2022).

[12] The Wyoming Decentralized Autonomous Organization Supplement, for example, defines a "smart contract" as "an automated transaction [cross-referencing W.S. 40-21-102(a)(ii)] or any substantially similar analogue comprised of code, script or programming language that executes the terms of the agreement..." W.S. 17-31-102(a)(ix). The statute goes on to specify that that a DAO may be member managed (if management is vested in the members) or algorithmically managed (if management is vested in the smart contract), that in addition to the usual requirements under the Wyoming LLC law the articles of organization must include a publicly available identifier of any smart contract used to manage or operate the DAO, and that except as otherwise specified the articles of organization, the smart contracts for a DAO will govern a list of basic activities and relations. W.S. 17-31-106.

[13] See UCC (Amended) Section 8-102(a)(15)(iii)(B).

[14] For example, a general partnership interest or interest in an unincorporated association would likely be deemed not an interest of a type dealt in or traded on a securities exchange or market, and therefore not a UCC security. UCC (Amended) Section 8-102(a)(15(iii)(A).

In a notable litigation relating to the status of a DAO as an entity, Ooki DAO was deemed to be an unincorporated association under California law and therefore subject to suit under the Commodities Exchange Act as a "person". *See* Commodity Futures Trading Comm'n v. Ooki DAO, 2023 WL 5321527 (N.D. Cal. June 8, 2023). Further, in Sarcuni v. bZx DAO, -- F. Supp. 3d --, 2023 WL 2657633 (S.D. Cal. Mar. 27, 2023), a motion to dismiss a putative class action was denied by the court, finding that the plaintiffs had sufficiently alleged that members of bZx DAO (which was the predecessor of Ooki DAO) constituted a general partnership under California law.

[15] ““Electronic” means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.” UCC (Amended) Section 1-201(b)(16A).

The U.S. Basel III Endgame Proposal: Update and Thoughts

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On September 18, 2023, the U.S. Basel III Endgame proposal was **published in the Federal Register**. The comment period ended on January 16, 2024, with the banking regulators (the Federal Reserve, the OCC, and the FDIC) having received hundreds of **comments** on the proposal. Acknowledging the many concerns raised in the comment letters, Federal Reserve Chairman Jerome Powell indicated in his March 2024 Congressional testimony that "**there will be broad material changes to the proposal**." On June 24, **Bloomberg reported** that the Federal Reserve has "shown other US regulators a three-page document of possible changes to their bank-capital overhaul that would significantly lighten the load on Wall Street lenders."

At this writing, it remains unclear whether (or when) the banking regulators will adopt a final rule or, one hopes, issue a re-proposal. The banking regulators have been faced with the daunting task of analyzing the many technical and substantive concerns raised in the comment letters. Several other factors are contributing to the uncertainty surrounding the timing and nature of the banking regulators' next step, including:

- Joint Rulemaking. All three banking regulators must agree on any changes to the Basel III Endgame proposal. Reaching agreement on the "broad material changes" promised by Chairman Powell could take considerable time and effort, particularly given the differing perspectives of the three banking regulators.
- FDIC Leadership Transition. On May 20, 2024, FDIC Chairman Martin J. Gruenberg **announced** that he would step down from his position once a successor is confirmed. This transition could have the effect of causing a delay (*g.*, FDIC may be reluctant to act until a new chair is in place) or an acceleration (*e.g.*, FDIC may seek to issue a final rule before Chairman Gruenberg steps down) of the rulemaking process.
- CRA/November Elections. Congressional Review Act ("CRA") considerations could motivate the banking regulators to move quickly to adopt a final rule. Under the CRA, Congress can overturn a regulatory agency's final rule if a joint resolution of disapproval is (1) introduced within 60 legislative days following the date the final rule, (2) approved by both houses of Congress, and (3) signed by the President (or vetoed by the President, followed by a Congressional override). By moving quickly to adopt a final rule, the banking regulators could attempt to ensure that the 60-day CRA window closes before the new Congress is seated (and, perhaps, the new President takes office) following the November 2024 elections.

- Supreme Court Decision on Agency Rulemaking. The U.S. Supreme Court's imminent decision in ***Loper Bright Enterprises v. Raimondo*** is likely to significantly limit the degree to which courts must defer to regulatory agencies under the long-standing *Chevron* Many of the comment letters assert that the Basel III Endgame proposal and related rulemaking process do not comply with requirements of the Administrative Procedure Act and existing caselaw construing such requirements. The *Loper* case could increase the susceptibility of any final rule to legal challenge, thus potentially encouraging the banking regulators to issue a re-proposal that is less susceptible to challenge.

Securitization Framework

As a reminder, the Basel III Endgame proposal includes significant changes to the mathematical model that assigns credit risk weights to securitization exposures. Both the existing "simplified supervisory formula approach" ("SSFA") and the proposed "securitization standardized approach" ("SEC-SA") incorporate a formula, referred to as

K_{SSFA}

and

$K_{(SEC\text{-}SA)}$

respectively, that calculates the average value of the marginal risk weighting function

$$K'(t) = e^{\left(-\frac{1}{p^{K_A}}\right)(t-K_A)}$$

over the interval $t = A$ to $t = D$. Under this function, A and D are the attachment and detachment points, respectively, of a securitization exposure, p is the supervisory calibration parameter (the p-factor), and K_A is the capital requirement of the underlying exposures, adjusted for defaults.

Of particular concern is the increase in the p-factor from 0.5 (under SSFA) to 1.0 (under the proposed SEC-SA). As the Structured Finance Association's ("SFA") **comment letter** explains, the increase in the p-factor from 0.5 to 1.0 effectively doubles the securitization capital surcharge and creates a host of anomalies. These points were emphasized by the SFA in a later meeting with the staffs of the banking regulators (pages 18-28 of the **meeting summary** contain helpful illustrations).

We note that p-factor value is a topic of concern not only in the U.S., but also on the UK and the EU. *See, e.g.*, **The UK's PRA Discusses Securitisation Capital Requirements and Basel 3.1**, by Alix Prentice, a partner in our London office.

Securitization market participants who are interested in the next stage of the Basel III Endgame rulemaking should consider joining SFA's **Basel III Task Force**, which is led by W. Scott Frame, the Chief Economist & Head of Policy at the SFA. Scott recently authored **De-Risking Banks through Synthetic Securitization and Credit-Linked Note Issuance**, which is an excellent overview of bank credit risk transfer ("CRT") transactions. CRT transactions would be significantly affected if the Basel III Endgame proposal is adopted in its current form.

We also bring to your attention the **Basel III Endgame Blog Series**, by Dr. Guowei Zhang and Dr. Peter Ryan of the Securities Industry and Financial Markets Association ("SIFMA"). Part X ("How the Basel III Endgame Could Impair Securitization Markets and Harm US Businesses and Consumers") is particularly insightful.

This article was previously featured in the firm's bi-weekly ***Cabinet News & Views*** newsletter.

Cadwalader Sponsors Diversity in Fund Finance Second Annual Summer Soiree: Suits & Soju

June 28, 2024

Cadwalader had a great time at the Second Annual Diversity in Fund Finance (“DFF”) Summer Soiree: Suits & Soju, held at **BARO by Chefs Society** and co-sponsored by Cadwalader, Fried Frank and Lloyds.

The event was bustling, with plenty of networking, delicious Korean tapas and tarot card reading by **Alex Angelo**. Natasha Puri (Director, Lloyds and Global Chair of DFF) presented the DFF mission statement and Fiona Cheng (Associate, Cadwalader and Committee Member of DFF) showcased BARO founder and CEO, Seolbin Park, and the incredible story behind her popular gastropub, including weathering the challenges faced by many small businesses during COVID.

In celebration of Pride month, Natasha and Fiona held a raffle to benefit **The Trevor Project**, which is the leading suicide prevention and crisis intervention nonprofit organization for LGBTQ+ young people.

Thank you to all who joined to celebrate Korean culture, to support a fantastic minority small business owner while benefiting the DFF community. We look forward to seeing you at the next!

Post Conference Report - Securitization in Fund Finance

June 28, 2024

Partner **Angie Batterson** and Special Counsel **Michael Celso Gonzalez** both enjoyed speaking at the DealCatalyst Securitization in Fund Finance Conference last week in New York.

Angie spoke on the panel "Overview of the Spectrum of Structures in Fund Finance" and Michael spoke on the panel "Motivations and Strategies for CFO Issuance."

Watch Angie's panel **here** and Michael's panel **here**. Recordings are available until June 30.

View the post conference report **here**.

Fund Finance Hiring

June 28, 2024

Fund Finance Hiring

Here is who's hiring in Fund Finance:

5C Investment Partners is hiring for a **Controller** to join their growing team. This role will support the development and management of the flagship BDC and broader credit products fund platform. Reporting to the Chief Financial Officer and based in New York City, this role will be responsible for the accuracy and completeness of filing requirements for public and private credit fund entities. Interested candidates can apply **here** or email **trupti.pullen@5Cinvest.com.**

5C Investment Partners is also seeking to add an **Operations Leader** to join their growing team who will support the development and management of the flagship BDC and broader credit products fund platform. Reporting to the Chief Financial Officer and based in New York City, this role will be responsible for accurately setting up securities and legal entities in all systems, for capturing loan and trade details, loan closing, trade settlement, booking, and loan administration activities, including reconciliations with custodians, trustees, and administrators across the public and private credit fund entities. Interested candidates can apply **here** or email **trupti.pullen@5Cinvest.com.**