SECURITIES AS COLLATERAL

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INTRODUCTION

ABOUT THE TITLE

The title "Securities as collaterals" may be somewhat confusing, however, please note that this is not the worst option available. Since generally, by collateral we mean assets used in secured transactions (for security purpuses) the title also could have been "Securities as securities".

Neither is easy to be comprehended without reading Dr Joanna Benjamin's fundamental work[1] explaining thororoughly that stocks, bonds and other instruments similar to these are called together "securities".

THE IMPORTANCE OF THE TOPIC

Using securities as collaterals has significant economic role especially in international business relations where the easy transferability and evaluation of this type of collateral makes it effortlessly available and the security interest wherein easily enforceable.

Typical types of arrangements secured by securities are margin loans provided by participants of organized security markets to other parties on such market or to clearing houses but traditional loans are also collateralized by securities widely[2].

In the area of project finance interests in the project company are usually collateralized and the money required to be deposited during the project usually needs to be invested in securities[3] and then collateralized as such.

[1] See DR JOANNA BENJAMIN, Interests in securities 1.02 (Oxford University Press 2000)
[2] See PHILIP R WOOD, Comparative Law of Security and Guarantees p58-59 (Sweet and Maxwell London 1995)
[3] See CARL S. BJERRE, International Project Finance Transactions: Selected issues under revised Article 9 p95 (American Bankrupcy Law Journal Winter 1999)

SCOPE OF THE WORK

Using securities as collaterals is regulated at least by two areas of law.

First by the law of secured transactions, that might be easy to find in the Unites States where UCC Article 9 contains most of its rules, but the elements of which are carefully camouflaged in other legislations under various names impossible to translate from one language to another. The second area is the law of (interests) in securities that has been subject to significant changes in the last 50 years.

Since we in Hungary have not had the chance to grow up together with such changes we are supposed to understand the results without graduality in an age when we do not certainly learn that fast. The purpose of this work is accordingly to make a bit easier to understand where we are now exactly and what the possible destinations of our improvement are.

In order to this I will firstly introduce the development of the present rules provided by the Uniform Commercial Code secondly I will reflect on the most important harmonization efforts from a Hungarian point of view such as the work of the UNIDROIT or that of the European Union.

Finally, I will describe the present Hungarian situation and possible ways of development in the light of the above.

THE US MODEL

PERFECTION OF A CHARGE[4]

The possible ways of making a charge valid and enforceable against third parties in case of securities as collaterals resemble to the methods used if the collateral is a certain debt. There are legislations based on the model of the possessory pledge and others applying non-possessory securities.

Possession in case of certificated securities can be obtained by physical delivery and/or endorsement, in other cases alternatives based on legal presumption (such as registration in the issuer's books) are needed.

The term, "control" under UCC Article 8 and 9. as we will see below includes both physical possession and all other means through which the creditor becomes the quasi-owner (being able to sell the securities without further involvement of the debtor).

Non-possessory charges in case of securities as collaterals generally mean registration (such as filing that is also possible under UCC Article 9 – see below) of the security interests in a special register for charges.

WHY THE US MODEL?

The question why it is worth taking UCC Article 9: Secured Transactions as an example when dealing with secured transactions issues was addressed by various authors. The reasons are both practical and theoretical.

[4] See PHILIP R WOOD, Supra note p60

Practically UCC Article 9 has been used as model for actual legal regimes[5] the most important for the author is the effect on the Eastern European modernization of secured transactions regulation.

On the theoretical side since the US has probably the most developed credit economy due at least partly to the achievements of UCC and we have no reason to doubt that countries committed to get closer to the level of development of the US will face problems in the future that may be more or less similar to those already solved on the other side of the Atlantic[6].

THE LEGISLATIVE APPROACH

Although the analysis of the general characteristics of UCC is out of the scope of the present work, its conceptual neutrality shall be mentioned. The drafters have never been felt their hands to be tied by legal traditions, meaning that they have freely merged legal phenomena with completely different historical or theoretical background into a new concept or term provided that such phenomena served the same purpose[7]. The categories of "security interest", "security entitlement" or the term "control" (all discussed in detail below) are examples for such new terms.

[5] Most provinces of Canada, the EBRD model Law on Secured Transactions (1994), the United Nations Convention on Assignment of Receivables in International Trade (approved by the General Assembly in 2001), the UNIDROIT Convention on International Interest in Mobile Equipment, the OAS Model Inter American Law on Secured Transactions and furthermore its influence on reform legislation in New Zealand, Eastern Europe and Mexico is mentioned by Harry C. Sigman member of the Drafting Committee for revised UCC. Article 9 See EVA-MARIA KIENINGER (ed.), Security Rights in Movable Property in European Private Law p54 (Cambridge University Press 2004.)

[6] On exportability of UCC Article 9 See TIBOR TAJTI, Comparative Secured Transactions Law p215 (Akadémiai Kiadó Budapest, 2002)

[7] This approach is called American realism. See MICHAEL BRIDGE, The English law of security: creditor friendly but unreformed in EVA-MARIA KIENINGER (ed.), Security Rights in Movable Property in European Private Law p81. Supra note
Not surprisingly the UNIDROIT efforts in order to create harmonized substantive rules on indirect securities holding use the same technique of "functional approach" or "neutrality as to language". See Preliminary draft convention on harmonized substantive rules regarding securities held with an intermediary; Explanatory Notes p19 (Unidroit Study Group on Harmonised Substantive Rules regarding Securities Held with an Intermediary, Rome December 2004; Unidroit 2004 Study LXXVIII – Doc 19) hereto: *"Explanatory notes"*

[8]The rules regarding the usage of securities as collaterals are situated in Article 9 and 8: Investment Securities of the UCC. The former contains provisions on the secured transaction related problems of law such as creation of security interest, perfection, attachment, the rules on priorities etc; and special rules regarding interests[9] in securities are parts of Article 8.

HISTORICAL DEVELOPMENT

The system created together by Article 8 and 9 was modernized in 1977 and 1994. These modernizations were reflections to the changing needs of those transferring and collateralizing securities.

In the pre-1977 period, securities were mostly on the market in the form of certificates and the securities were transferred by physical delivery of the certificates and by registering the transfer on the issuer's books[10]. Accordingly, they could be regarded as pure tangibles therefore the application of the general rules of Article 9 (creation – and perfection – of security interests on securities by giving possession of the certificate to the creditor) sufficed.

The 1977 reform addressed the fact that the increasing number of security transactions increased the costs and risks associated to the physical transfer of the certificates. Certificates that were invented to make life easier (by incorporating the shareholders' rights and making possible to transfer or pledge such rights by way of simple delivery of possession with the more or less full exclusion of adverse claims) became inconvenient.

The more legalistic problem was that when certificates did not represent the share of stock any longer, the tangible nature of securities faded. The perfection of security rights on

[8] The next two paragraphs are based on JAMES J WHITE, Secured Transactions p275-276, (Snd edition American Casebook Series Thomson West 2002)

[9] Creation of security interests or other interests (for example ownership) in a security can not be analyzed regardless to each other. The way how transfer of title is affected in a security is always somewhat similar to the way security interests are perfected. With the obvious exception of filing, which, however, is not the most important method of perfection of security interests in securities.

[10] Therefore issuers issued shares in stock directly to the investors, See MARK HARGRAVE, MARK OVINGTON A practitioner's guide to secured lending under revised Article 8: Everything is under control p400 (Annual Review of Banking Law 1997)

intangibles cannot be made by possession (they cannot be possessed in a way physical objects – or certificates – can be), accordingly the appropriate method for perfection seemed to be filing. Not a method easily digested by participants of capital markets.

The 1977/78 amendments inserted secured transactions related provisions to Article 8[11], envisaging a system in which ownership and transfer of shares would be evidenced mostly by the registry of the issuer effecting the changes of the registry by way of sending notices to the issuers instead of using issued certificates[12]; or in limited number of cases by transfer of physical certificates. Albeit in significant parts of the market this may be true, the modern system of holding securities has a different logic.

THE INDIRECT HOLDING SYSTEM

This different logic is based on what is called indirect holding system, which new system is covered by the 1994 reform amendments of UCC[13] parallel with the modernized rules of the older direct holding. The 1994 rules on the creation, perfection and priority of security interests in investment property[14] are effective law in most States.

In the indirect holding system, transfers are evidenced in the registers of the brokers (securities intermediaries) without modifying the issuers' registry or delivery of physical certificates. Drafters of the present rules were led by the neutrality principle between indirect and direct holding[15], however, in the following lines I will focus on indirect holding since this raises more practical and legal problems.

[11] That is not obviously the place they belong See MARK HARGRAVE, MARK OVINGTON, Supra note p398

[12] The system created was therefore one assuming uncertificated securities in a direct holding system. See MARK HARGRAVE, MARK OVINGTON, Supra note p402 Here we can see that uncertification does not necessarily mean indirect holding.

[13] Uniform Commercial Code Revised Article 8. Investment Securities, Proposed Final Draft (Submitted to the Council of the Members of the American Law Institute for Discussion at the Seventy-First Annual Meeting on May 17,18,19 and 20, 2004)

[14] These amendments were inserted to Article 9 in section 9-115 although in 1999 such rules were distributed among the respective provisions of Article 9 See JAMES J WHITE p277 Supra note.

[15] See Uniform Commercial Code Revised Article 8. Investment Securities, Proposed Final Draft p4 Supra note

The most important feature of the indirect holding system is that the right the holder of the security has cannot be described by traditional terms such as ownership or title. The reason for this is that there is no straight connection between the issuer and the holder of the security. The issuers' records do not identify the ultimate holders (beneficial owners) of the securities only that of the intermediaries (brokers)[16].

It means that the intermediary – which is in 60-80 per cent of publicly traded US securities the Depository Trust Company (DTC) thorough its nominee Cede & Co[17] – is registered in the issuers' books as the owner of the shares. The DTC then operates registers – securities accounts – to further intermediaries, banks, brokers etc and at the end of the chain is the beneficial "owner" of the shares on the account of whom such 'shares' are credited.

In most cases the records of each entity only indicates the details of (securities held by) the party directly below it. The trades among the customers of the intermediaries are netted among broker dealers, banks, and the National Securities Clearing Corporation (NSCS).

Since according to general principles of logic and law one thing can not be fully owned by each of two or more persons such beneficial owners (security holders) can not be owners of the shares. Which is not a big deal in Anglo-Saxon countries where the question is not "who is the owner?" but "who has more right in the asset?"[18].

[16] See GEORGE T MORRISON, JOHN T. DONLON, Pending revisions to Article 8 and 9 of the Florida UCC: An opportunity for Florida to merge onto the information superhighway p45 (Florida Bar Journal, January 1998)

[17] See PHILIP R WOOD, Supra note p125

[18] See NORBERT CSIZMADIA Tulajdon, mint biztosíték? (Title as security device?) p6 (Polgári jogi kodifikáció 1-2/2003 p3-22)

Instead of forcing the newly developed phenomenon into the old terms, the drafters of UCC in Article 8-501[19] named the security holders' (group of personal and property) rights in the indirect holding system[20] as "security entitlement"[21].

This is one of the three logically possible ways of characterizing the rights of the security holders'. The other two are handling them as pure personal rights against the intermediary or as ownership of the securities deposited (the latter is obviously problematic in case of fungible accounts)[22].

The consequence of the approach applied by UCC is that indirect holders of securities are not able to provide their securities as collaterals (which can be done by a direct holder) but only their security entitlements[23].

The practical approach of Article 9 and 8 relatively easily handled this swift between the two completely different collateral type, however, the continental laws where different security interests can be attached to different types of collaterals the scope of available forms of securing a credit can be different depending on the collateral being a security or a security entitlement under US terms.

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[19] § 8-501 "*(b) Except as otherwise provided in subsections (d) and (e), a person acquires a* ***security entitlement*** *if a securities intermediary:*
(1) indicates by book entry that a financial asset has been credited to the person's securities account;
(2) receives a financial asset from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person's securities account; or
(3) becomes obligated under other law, regulation, or rule to credit a financial asset to the person's securities account.
(c) If a condition of subsection (b) has been met, a person has a security entitlement even though the securities intermediary does not itself hold the financial asset.
(d) If a securities intermediary holds a financial asset for another person, and the financial asset is registered in the name of, payable to the order of, or specially indorsed to the other person, and has not been indorsed to the securities intermediary or in blank, the other person is treated as holding the financial asset directly rather than as having a security entitlement with respect to the financial asset.
(e) Issuance of a security is not establishment of a security entitlement".

[20] In the European legal literature the same distinction exists. The same group of rights "*the assets of a client for whom an intermediary holds securities (or interests in securities) on an unallocated basis, commingled with the interests in securities of other clients.*" is called „Interests in securities" as opposed to „securities". See DR JOANNA BENJAMIN, 1.04 Supra note

[21] See Uniform Commercial Code Revised Article 8. Investment Securities, Proposed Final Draft p6 Supra note

[22] See ROY GOODE The Nature and Transfer of Rights in Dematerialised and Immobilised Securities p119 in The Future for the Global Securities Marked edited by Fidelis Oditah (Clarendon Press Oxford, 1996)

[23] See Uniform Commercial Code Revised Article 8. Investment Securities, Proposed Final Draft p7 Supra note

TYPES OF COLLATERAL[24] OR WHAT DO WE MEAN BY SECURITIES UNDER THE RELEVANT PROVISIONS OF UCC[25]

Four types of collaterals should be distinguished for our purposes under UCC Article 8 and 9. Securities are stocks (but generally not interests in partnerships), bonds and government securities. A security is certificated if the issuer issues certificates uncertificated if it does not. Security entitlement is the interest (the pool of rights as defined above) of an investor on whose securities account a "security" is credited by its broker who (the broker or maybe another intermediary) is actually registered in the books of the issuer.

Securities account is basically an account operated by a broker or bank for holding securities.

Investment property is a collective term for securities security entitlement and securities account (and furthermore commodity contract and commodity account that will not be addressed in the present thesis[26]).

Since the 1994 revision of UCC it has been possible to create and perfect a security interest in a securities account without perfection in the individual and changing shares credited on such account (floating liens on Investment Property[27]). This was a major step since the secured financing practice was focusing on floating liens on inventory, accounts and other constantly changing collateral.

As regards distinguishing between collaterals the reasonable identification standard as a general rule needs to be mentioned, according to which if the identity of the collateral is objectively determinable the identification will suffice (for example mentioning 100 'shares'

[24] See MARK HARGRAVE, MARK OVINGTON, Supra note p405-409

[25] The text of UCC provided by http://www.law.cornell.edu/ucc/ will be analyzed in this work. Since UCC will only be regarded as a model for regulation the various laws implementing UCC in the different States are not relevant for the purposes of the thesis.

[26] Those are excluded from Article 9 as well. See JOSEPH B: C KLUTZ, DAVID LINE BATTY, NICOLE NICHOLS, How to be secure when your collateral is a security: A guide to the creation and perfection of security interests in investment property under the 1994 revisions to the Uniform Commercial Code p187 (North Carolina Banking Institute, April 2000)

[27] See MARK HARGRAVE, MARK OVINGTON Supra note p413

held on a securities account instead of description of the security entitlement regarding such shares)[28].

ATTACHMENT AND PERFECTION[29]

First of all Article 9-203 on attachment – the creation of the security interest as between creditor and debtor for which three elements are needed: (i) security agreement (ii) value given by the secured party and (iii) rights given to the debtor in the collateral[30] –follows the main rule for any other type of collateral. One exception needs to be noted: attachment of a security interest in a securities account is also an attachment of a security interest in the security entitlements carried in the securities account (9-203 (h)).

According to Article 9-312(a)[31] perfection is possible through filing regarding all types of investment property[32]. Therefore, the general method of perfection applicable to most types of movable property is also available in case of securities. However, as noted above capital market players are not necessarily prepared for the burden of filing and searching files.

UCC also provides for methods of automatic perfection. First security interests granted by security intermediaries (as debtors) in their investment property are automatically perfected and the second is the brokers' lien that is created by law when the buyer of financial assets has not fulfilled its payment obligation[33] towards its broker as seller[34]. In the latter case, the (seller) intermediary who credited the security (entitlement) on the account of the buyer has a perfected security interest on such securities (entitlements).

[28] See MARK HARGRAVE, MARK OVINGTON, Supra note p411
[29] The provisions cited are those indicated by JAMES J WHITE p277 Supra note
[30] See DOUGLAS J. WHALEY, Secured Transactions §117 (Gilbert Law Summaries Barbri 2002)
[31] § 9-312. (a) „A security interest in *chattel paper*, negotiable documents, *instruments*, or *investment property* may be perfected by filing."
[32] The first time in history from 1994. See MARK HARGRAVE, MARK OVINGTON p398 Supra note
[33] Although brokers' lien may be subordinated to other/later security interests in control agreements as suggested by JOSEPH B: C KLUTZ, DAVID LINE BATTY, NICOLE NICHOLS See Supra note p203
[34] The formal called the weak, the latter the strong automatic perfection. See MARK HARGRAVE, MARK OVINGTON, Supra note p418

More important is for our purposes that under Article 9-313[35] in case of a certificated security the perfection of the security interest can be made by delivery of a certificated security. This practically means that if there is a certificate registered to the debtor; giving possession to the creditor is delivery (8-301[36]) and therefore perfection. Thus, the pre-1977 method of perfection is back in the Code, although the reasons urged the 1977 reform (physical impossibility of handling the enormous number of daily transactions by moving certificates) are still present.

The probably mostly used way provided by UCC for the perfection of a security interest in securities in the age of indirect holding systems is obtaining control[37].

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[35] § 9-313. (a) *„Except as otherwise provided in subsection (b), a secured party may perfect a security interest in negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral. A secured party may perfect a security interest in certificated securities by taking delivery of the certificated securities under Section 8-301."*

[36] § 8-301. DELIVERY.
(a) Delivery of a certificated security to a purchaser occurs when:
(1) the purchaser acquires possession of the security certificate;
(2) another person, other than a securities intermediary, either acquires possession of the security certificate on behalf of the purchaser or, having previously acquired possession of the certificate, acknowledges that it holds for the purchaser; or
(3) a securities intermediary acting on behalf of the purchaser acquires possession of the security certificate, only if the certificate is in registered form and is (i) registered in the name of the purchaser, (ii) payable to the order of the purchaser, or (iii) specially indorsed to the purchaser by an effective indorsement and has not been indorsed to the securities intermediary or in blank.
(b) Delivery of an uncertificated security to a purchaser occurs when:
(1) the issuer registers the purchaser as the registered owner, upon original issue or registration of transfer; or
(2) another person, other than a securities intermediary, either becomes the registered owner of the uncertificated security on behalf of the purchaser or, having previously become the registered owner, acknowledges that it holds for the purchaser.

[37] § 9-314. PERFECTION BY CONTROL.
(a) [Perfection by control.]
A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral under Section 9-104, 9-105, 9-106, or 9-107.
(b) [Specified collateral: time of perfection by control; continuation of perfection.]
A security interest in deposit accounts, electronic chattel paper, or letter-of-credit rights is perfected by control under Section 9-104, 9-105, or 9-107 when the secured party obtains control and remains perfected by control only while the secured party retains control.
(c) [Investment property: time of perfection by control; continuation of perfection.]
A security interest in investment property is perfected by control under Section 9-106 from the time the secured party obtains control and remains perfected by control until:
(1) the secured party does not have control; and
(2) one of the following occurs:
(A) if the collateral is a certificated security, the debtor has or acquires possession of the security certificate;
(B) if the collateral is an uncertificated security, the issuer has registered or registers the debtor as the registered owner; or
(C) if the collateral is a security entitlement, the debtor is or becomes the entitlement holder.

Article 9-106[38] defines control via reference to Article 8-106[39]. Control is a term invented for the purposes of the 1994 amendments. In order to obtain control the creditor shall be put in a position in which he can freely sell the securities without further involvement of the debtor[40]. Need for a third party might be the case in order to obtain control in case of a uncertificated security (via control agreement between the secured party and the issuer under which the issuer agrees to follow the secured party's instructions[41]) and furthermore in case of a security entitlement (when it is possible to obtain control via the tripartite agreement of the creditor the debtor and the intermediary in which the intermediary agrees to follow the instructions of the

[38] § 9-106. (a) *„A person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-106.*"
…
(c) *„A secured party having control of all security entitlements or commodity contracts carried in a securities account or commodity account has control over the securities account or commodity account."*

[39] § 8-106. CONTROL.
"(a) A purchaser has "control" of a certificated security in bearer form if the certificated security is delivered to the purchaser.
(b) A purchaser has "control" of a certificated security in registered form if the certificated security is delivered to the purchaser, and:
(1) the certificate is indorsed to the purchaser or in blank by an effective indorsement; or
(2) the certificate is registered in the name of the purchaser, upon original issue or registration of transfer by the issuer.
(c) A purchaser has "control" of an uncertificated security if:
(1) the uncertificated security is delivered to the purchaser; or
(2) the issuer has agreed that it will comply with instructions originated by the purchaser without further consent by the registered owner.
(d) A purchaser has "control" of a security entitlement if:
(1) the purchaser becomes the entitlement holder; or
(2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder, or
(3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.
(e) If an interest in a security entitlement is granted by the entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control.
(f) A purchaser who has satisfied the requirements of subsection (c) or (d) has control even if the registered owner in the case of subsection (c) or the entitlement holder in the case of subsection (d) retains the right to make substitutions for the uncertificated security or security entitlement, to originate instructions or entitlement orders to the issuer or securities intermediary, or otherwise to deal with the uncertificated security or security entitlement.
(g) An issuer or a securities intermediary may not enter into an agreement of the kind described in subsection (c)(2) or (d)(2) 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. An issuer or securities intermediary that has entered into such an agreement is not required to confirm the existence of the agreement to another party unless requested to do so by the registered owner or entitlement holder".

[40] See Uniform Commercial Code Revised Article 8. Investment Securities, Proposed Final Draft p8 Supra note

[41] The practical concern is that issuers may be reluctant to enter into such agreement. See MARK HARGRAVE, MARK OVINGTON Supra note p416

creditor[42]). We should not forget that the control agreement shall be express the mere course of dealing between the creditor and the intermediary would not suffice[43].

Notwithstanding obtaining control via tripartite control agreements transfer of control is apparently similar to transfer of title (or entitlement) e.g. the creditor as far as the rest of the world is concerned appears to be owner.

And this may be a reason for preferring tripartite control agreements by debtors, because in the control agreement there is the opportunity to regulate (to narrow) the possible usage of the collateral by the creditor[44].

The second reason that supports obtaining control when one intends to perfect a security interest in a security (entitlement) is that control is also a sufficient mechanism for attachment therefore the two steps of creating a security interest and making it enforceable *vis-a vis* third parties can be done in one single step[45].

PRIORITY

The third reason after convenience for using control, as perfection method is that Article 9-328[46] sets a priority rule according to which a security interest perfected by control prevails

[42] However, GEORGE T MORRISON, and JOHN T. DONLON note that the stock broker is not obligated to conclude such agreement therefore „major players of security account based lending marked will be affiliates of stock brokers" See GEORGE T MORRISON, JOHN T. DONLON p49 Supra note

[43] See the reference of JOSEPH B: C KLUTZ, DAVID LINE BATTY, NICOLE NICHOLS to the First National Bank of Palmerton v. Donaldson, Lufkin & and Jenrette Securities Corp regarding the exclusion of an implied control agreement. Supra note p198

[44] See MARK HARGRAVE, MARK OVINGTON Supra note p399

[45] See GEORGE T MORRISON, JOHN T. DONLON p49 Supre note

[46] § 9-328. PRIORITY OF SECURITY INTERESTS IN INVESTMENT PROPERTY.
„The following rules govern priority among conflicting security interests in the same investment property:
(1) A security interest held by a secured party having control of investment property under Section 9-106 has priority over a security interest held by a secured party that does not have control of the investment property.
(2) Except as otherwise provided in paragraphs (3) and (4), conflicting security interests held by secured parties each of which has control under Section 9-106 rank according to priority in time of:
(A) if the collateral is a security, obtaining control;
(B) if the collateral is a security entitlement carried in a securities account and:
(i) if the secured party obtained control under Section 8-106(d)(1), the secured party's becoming the person for which the securities account is maintained;
(ii) if the secured party obtained control under Section 8-106(d)(2), the securities intermediary's agreement to comply with the secured party's entitlement orders with respect to security entitlements carried or to be carried in the securities account; or

over another one perfected by filing even if the filing was made before the competing secured party perfected its interest by control. If more creditors obtained control, the one who did it earlier has priority over those obtaining control later[47].

Conflict can also occur between the security entitlement holder and the security intermediary's secured creditor. The financial assets held by the securities intermediary's on behalf of their clients are generally not subject to the claims of the intermediaries' creditors[48]. The issue was addressed by the US courts in the Drage case[49] where a securities intermediary granted a security interest in a financial asset maintained on its client behalf. Since the security interest was perfected the client had no mean to reclaim it after it was transferred (after the intermediary's default) to satisfy the claim of the intermediary's creditor. Obviously, the intermediary breached its obligations *vis-à-vis* its client, but this did not invalidate the transfer of the financial assets to the creditor invalid. The suggested solution is to select one's broker carefully; federal regulative requirements prevent US brokers from such transactions for example.

(iii) if the secured party obtained control through another person under Section 8-106(d)(3), the time on which priority would be based under this paragraph if the other person were the secured party; or
(C) if the collateral is a commodity contract carried with a commodity intermediary, the satisfaction of the requirement for control specified in Section 9-106(b)(2) with respect to commodity contracts carried or to be carried with the commodity intermediary.
(3) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.
(4) A security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by another secured party.
(5) A security interest in a certificated security in registered form which is perfected by taking delivery under Section 9-313(a) and not by control under Section 9-314 has priority over a conflicting security interest perfected by a method other than control.
(6) Conflicting security interests created by a broker, securities intermediary, or commodity intermediary which are perfected without control under Section 9-106 rank equally.
(7) In all other cases, priority among conflicting security interests in investment property is governed by Sections 9-322 and 9-323."

[47] See DOUGLAS J. WHALEY, Supra note p115
[48] See PHILIP R WOOD, Supra note p126
[49] See cited by JOSEPH B: C KLUTZ, DAVID LINE BATTY, NICOLE NICHOLS Supra note p199

PROCEEDS[50]

The general rule of Article 9 is followed regarding proceeds as far as investment property is concerned; therefore, a security interest in any investment property automatically includes security interest in the proceeds of such investment property as well[51]. However, the parties have the right to agree otherwise.

ENFORCEMENT[52]

Under UCC Article 9 upon the default of the debtor the secured creditor has the right to repossession (which is not of primary importance in our case since the general method of perfection is obviously not filing, thus the creditor initially has possession or control).

After repossession, creditors are generally entitled either to strict foreclosure (to appropriate the collateral free from debtor's rights) or to disposition[53]. Disposition must be done in a commercially reasonable way, involvement of courts is not necessary[54].

[50] See MARK HARGRAVE, MARK OVINGTON Supra note p413

[51] This is not in any case very evident only in case of cash proceeds (otherwise filing or taking control is necessary under certain conditions). See JOSEPH B: C KLUTZ, DAVID LINE BATTY, NICOLE NICHOLS Supra note p195

[52] See TIBOR TAJTI p189-190

[53] With some rules on debtor protection from which the 'proposal and objection model' is generally applicable. Before strict foreclosure, the debtor and certain creditors shall be notified and only if there is no objection may the secured party effects strict foreclosure.

[54] However, not excluded as well, and if applied provides certainty regarding the commercial reasonables of the sale of the collateral.

INTERNATIONAL HARMONISATION

HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW

The purpose of the Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (Hague Securities Convention[55]) - as its name suggests - is providing for clear guidelines in the matter of choice of law questions in the area of securities held by an intermediary.

The rule given is not based on older efforts that tried to locate the securities account but focuses on the contract between the account holder and its intermediary. Consequently, the parties express agreement on the law applicable to their account agreement determinates the law applicable to all issues governed by the Convention (if the intermediary has at the time of agreement on the governing law, an office in the state the law of which the parties selected).

If the governing law cannot be defined under these terms, the result of the application of the supplementary rules of the Convention will ultimately be the law of the state where the intermediary is incorporated.

This selected law applies to all issues listed in Article 2 (1) of the Convention, including *"the requirements, if any, for the realization of an interest in securities held with an intermediary"*.

The weaknesses of the Hague Securities Convention lie in the cross border nature of capital market transactions. Contractual, corporate, insolvency, property and securities law governed elements of a certain transaction might be governed by different jurisdictions regardless the rules adopted in the Convention[56].

[55] Adopted on 13 December 2002
[56] Explanatory notes p10 Supra note

EUROPEAN UNION

The Settlement Finality Directive[57] deals mainly with the effect of insolvency procedures on settlement systemys. From a secured transaction prospective most memorable is the rule that *"security provided to central banks in connection with participation in a settlement system is insulated from the effects of insolvency law"*[58]. Additionally the second report of the Giovanni group[59] emphasized that a common framework for rules on securities held by intermediaries is necessary in order to remove barriers on common capital markets.

THE FINANCIAL COLLATERAL DIRECTIVE[60]

The Financial Collateral Directive in its whereas closes refers to the choise of law rules of the Settlement Finality Directive that are not completely consistent with that of the Hague Securities Convention[61].

The Financial Collateral Directive applies only in relations where the parties to a transaction are professional players on the capital market. Member States can opt out the provision under which one of the parties may be any person (not including natural persons.). If a natural person is involved into the transaction, the Directive does not apply[62].

[57] Directive 98/26/EC of 19 May 1998 on settlement finality in payment and secutirites settlement systems; See at http://europa.eu.int/eur-lex/en/lif/reg/en_register_1040html

[58] Explanatory notes p16 Supra note

[59] See a more detailed analysis of their work at Explanatory notes p16 Supra note

[60] Directive 2002/47/EC of 6 June 2002 on financial collateral agreements See at http://europa.eu.int/eur-lex/en/lif/reg/en_register_1040.html

[61] Section (7) *„Whereas the principle in Directive 98/26/EC, whereby the law applicable to book entry securitites provided as collateral is the law of jurisdiction where the relevant register, account or centralised deposit system is located, should be extended.."* See the exact rules in Article 9 of the Directive. There are certainly cases where the application of the Hague Securities Convention has the same result, althogh the acknoledgement of party autonomy is missing from the Directives.

[62] Article 1 of the Financial Collateral Directive

The policy is obviously to protect natural persons, although as we will see at the considerations in the UNIDROIT harmonization efforts this way they are "protected" from cheaper credit opportunities as well.

TYPES OF COLLATERAL

The Directive's scope of applications covers cash and financial instruments the latter meaning shares in companies and other securities equivalent to shares in companies and debt securities such as bonds negotiable on the capital market or any other securities that give the right to acquire shares, bonds or other securities regardless their form or name.

ATTACHMENT AND PERFECTION

The Directive has a functional approach just like UCC Article 9, therefore does not differentiate between the creation of security interest by the transfer of limited rights in the collateral or by title transfers (such as repo transactions). Member States shall let title transfers take effect and close-out netting possible in case of enforcement events[63].

The Directive imposes an obligation on Member States to extinguish all formal requirements for the creation, validity, perfection, enforceability of any financial collateral agreement. However, such financial collateral agreements need to be evidenced in writing or in a legally equivalent manner[64].

PRIORITY

The Directive does not contain rules on priority among competing security interests.

[63] Article 6 of the Financial Collateral Directive
[64] Article 3. 1. of the Financial Collateral Directive

ENFORCEMENT

Above the equal treatment of title transfers and traditional security devices, the other fundamental characteristic of the Directive is that it contains efficient, let us say creditor friendly rules on enforcement[65].

Without the parties' agreement to the contrary in case of the collateral givers default, the collateral taker is entitled to sell or appropriate[66] the collateral and setting of its value agains or applying their value in discharge of the relevant financial obligations[67].

The realization of the financial collateral shall not be subject to prior notice to the collateral giver or approved by any court public officer or other person or conducted by public auction and is not only permitted after the ellapse of certain time[68].

Certain generally applied insolvency provisions shall be diminished from the Member States' insolvency law regarding most importantly financial collateral agreements concluded on the commencement day of the insolvency procedure prior to the order or decree making such commencement[69].

RIGHT TO USE THE COLLATERAL

The right to use the collateral is subject to the parties' agreement, however, Member States shall acknowledge such agreement[70].

[65] Most probably this is from what natural persons are protected.
[66] Although appropriation is only permitted if the parties agreed accordingly including in their agreement the method of valuation of the financial instrument. And additionally Member States that do not allow appropriation on 27 June 2002 are not obliged to recognize it (Article 4. 3. of the Financial Collateral Directive).
[67] Article 4. 1. of the Financial Collateral Directive.
[68] Article 4. 4. of the Financial Collateral Directive
[69] Article 8. of the Financial Collateral Directive
[70] Aritcle 4.6. of the Financial Collateral Directive

UNIDROIT

The work on a document that would harmonize substantive rules of indirect held securities commenced in September 2001 and has not completed yet. The purpose is to eliminate the risks deriving from the changing market practices in the last 50 years and the enormous number of cross-border transactions made on capital markets.

The problems faced were those that initiated the above-discussed UCC revisions (indirect holding systems with dematerialized or immobilized shares). Although the drafters intend to avoid the term "indirect holding" since it does not reflect to the differences between national legislations in force. There are jurisdictions where intermediaries obtain certain legal position and the rights of the account holders is derived from the right of the intermediary, however, in other countries the intermediaries have no right in the securities held at all they are simply considered as book-keepers[71]. "Held with" or "held through" are the proposed[72] terms instead. The present risks are identified by the UNIDROIT study group as conceptual first[73].. Several countries attempt to describe the modern system of holding through intermediaries by the traditional terms of custody or deposit[74]. It is clear that such traditional terms were created in times were securities existed mostly in certificated form therefore could be treated as tangibles.

The examples[75] given by the explanatory notes for the types of risk in case of a legal system not adjusted to the modern needs are memorable.

[71] As we will see the Hungarian system belongs to the second model, however, with certain inconsistencies.
[72] Explanatory notes p5 Supra note
[73] Explanatory notes p9 Supra note
[74] Explanatory notes p8 Supra note The source does not mention "ownership", however, it may also be important as we have seen in the US, where a new term was invented in order to describe the rights of the investors against the intermediaries (and the rights of intermediaries as against other intermediaries upper in the multi-tier system)
[75] Explanatory notes p9-10 Supra note

First of all if intermediaries have a right in (or connected to) the securities held by them it means that theoretically each of such rights can be subject to security interests (can be granted as collateral). If this is the case, there is urgent need for rules on priority[76].

Secondly, the risk of re-characterization is mentioned. This reflects to the problem that in legal systems where there is tension between traditional terms and current market development the terms used to describe legal relations might be interpreted by courts contrary to the parties' will.

Thirdly, procedures such as filing[77] required to create or perfect security interests might be on the one hand burdensome and time-consuming, and on the other hand it can be proved problematic to choose between the possible methods provided by law. Wrong decision on this issue may have unpleasant consequences e.g. lack of (or invalid) security interest.

Finally upper tier attachment is a substantial issue. In case of commingled securities accounts on the upper level of intermediaries since securities that are subject to the actual attachment can not be identified the upper tier intermediary might have no alternative but to freeze the whole account on the name of the lower level intermediary. This means that all the customers of the lower level intermediary will be affected by the attachment instead of the one that should be.

Since neither the Hague Securities Convention nor the existing EU legislation regulates throroughly the substantive law regarding the above problems the UNIDROIT assumed the task to provide for such substantive law.

[76] Additionaly rules on priority may be necessary to settle conflicts between the clients of the intermediary and such clients' secured creditors.

[77] Or formal requirements such as notarisation in Hungary as detailed below.

TYPES OF COLLATERAL

The scope of the UNIDROIT draft convention[78] (hereto: "UNIDROIT draft convention") only covers securities[79] held through intermediaries, however, it does not matter whether the intermediary has rights to the securities on its costumer accounts or not under national[80] law.

ATTACHMENT AND PERFECTION

Parties can create security interests on securities under the scope of the UNIDROIT draft convention by disposition and acquisition[81] of the securities or via methods not requiring disposition or acquisition[82] and by way of other methods[83].

Therefore, security interests created by outright transfers are acknowledged[84] and additionally based on an agreement between the collateral taker and the collateral giver (account holder) security interest can be granted via a "designating entry" or a control agreement.

In case of security interest granted to the intermediary itself there is no need for designating entry or control agreement according to the UNIDROIT draft convention. Whether the security interests created in the above ways are effective against third parties or not depends on the declaration of the signatory states to the UNIDROIT draft convention.

[78] The text quoted below is the Preliminary Draft Convention on Substantive Rules Regarding INtermediated Securities (as adopted by the Committee of Governmental Experst at its third session, held in Rome 06-15 November 2006) See at www.unidroit.org, UNIDROIT Study LXXVIII – Doc57.

[79] As Article 1 (a) of the UNIDROIT draft convention defines: *"Securities means any shares, bonds or other financial instruments or financial assets (other than cash), which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention"*

[80] Non-Conventional law (Article 9 of the UNIDROIT draft convention)

[81] Article 7. 4. of the UNIDROIT draft convention

[82] Article 8. of the UNIDROIT draft convention

[83] The list is based on the Explanatory notes p28 Supra note, although the indicated article numbers refers to the text of the UNIDROIT draft convention

[84] And shall be acknowledged by the contracting States as well under Article 27 of the UNIDROIT draft convention.

PRIORITY

Security interests created under the rules of the UNIDROIT draft convention have priority over security interests created under non-Convention laws.

Among themselves Convention based security interests basically rank according to the time of the commencement of the agreement granting the interest (provided that the intermediary itself is the collateral taker) or when the designating entry is made or when the control agreement is entered into and (if applicable) notice is given to the relevant intermediary

Subordination of interests by the parties' agreement is permitted to the extend acknowledged by non-Convention law[85].

ACQUISITION BY INNOCENT THIRD PARTIES

Acquisition of an innocent person of the intermediated securities terminates prior interests in the securities[86]. This rule does not take into consideration the probably "*in rem*" nature of interests in securities.

In rem nature of rights seems to be sacrificed for commercial market safety. A phenomenon hardly digested by civil law lawyers.

ENFORCEMENT[87]

Upper tier attachement is prohibited, because of the risks attached to it.

According to the present text of the draft collateral takers have firm rights on the occurrence of an enforcement event. The collateral takers may (nothwidstanding the commencement of an insolvency proceeding in respect of the collateral provider and without notice to the collateral giver or being approved by any court, public officer or other person or being the

[85] Article 13 of the UNIDROIT draft convention
[86] Article 12. of the UNIDROIT draft convention
[87] The rules on enforcement and on the right to use the collateral are practically identical to those of the Financial Collateral Directive.

realization conducted by public auction) realize the collateral securities or selling them and applying the proceeds of the sale towards the discharge of the relevant obligations or appropriate the collateral securities and set off their value towards the discharge or the relevant obligations or operate close out netting provisions[88].

The extremely creditor friendly nature of the above – especially in the light of the following Hungarian regulations – explains exluding natural persons as collateral givers from the scope of the regulation. However, it was noted that this would mean the exclusion of natural persons from the pleasant credit conditions that might be provided by credit institutions if such enforcement rules apply[89].

RIGHT TO USE THE COLLATERAL

The available text of the UNIDROIT draft convention allows collateral takers to use the securities in their possession only if the collateral agreement stipulates so. If it does and the collateral taker exercises its right to use it is supposed to replace the collaterals originally transferred or to transfer equivalent collateral not later than the discharge of the relevant obligations.

[88] Article 28 of the UNIDROIT draft convention
[89] See Explanatory notes p35 Supra note

THE HUNGARIAN REGULATION

THE LEGISLATIVE APPROACH

Hungary is a civil law legal system evolved under strong German influence. The transition of Hungary from a plan-, to a market economy needed reform regulation since the plan-economy based on the principles of communism did not need (or even worse allow) the existence of credit mechanisms.

With the sole existence of state-owned business associations obviously securities and the market of such was unknown. The issue (securities as collaterals) analyzed in the present thesis did not generate too much concern in the legal community until the end of the 80's[90].

The Hungarian regulation on secured transactions is based on the modifications of the Hungarian Act IV of 1957 on the Civil Code (hereto: Ptk.) in 1996 and 2000[91]. Since the reforms based on the EBRD model law referred to above there have been two *in rem* security devices in the Ptk. a unitary one called charge[92] and another one for special types of collaterals (cash and securities): security deposit[93].

There are opinions according to which security deposit should be (is) a special type of charge and therefore needed to be renamed in the Ptk since the present relationship between the two vehicles is not crystal-clear[94].

In rem securities named by the Ptk have crucial importance since as opposed to the concept of UCC Article 9 *in rem* rights and therefore *in rem* securities have a *numerus clausus* under

[90] Notwithstanding, the well-developed Hungarian legal practice and jurisprudence on these areas that existed before the communist regime.

[91] About the history of the present Hungarian legislation see TIBOR TAJTI, Supra note p293-201

[92] Section 251-269 of the Ptk.

[93] Section 270-271/A of the Ptk. (The definition can be found at section 270. § (1): *"Financial collateral may be provided under a financial collateral arrangement to secure a claim in the form of cash, money on account, security and other financial instruments specified in specific other legislation, upon delivery of the collateral. If the financial collateral pledged is some other thing, the regulations on charges shall apply..")*

[94] See NORBERT CSIZMADIA A tőkepiaci értékpapírok "tulajdona" átruházása és megterhelése("Ownership" transfer and charge of capital market securities) p34 (Polgári jogi kodifikáció 5-6/2004 p34-43)

Hungarian law. It means that new rights that are effective against the world cannot be created by the agreement of parties to a certain contract.

There has been no intention in the Hungarian legislators to pool all the possible *in rem* security interests into one category, and make common rules for them, accordingly outright collateral transfers (or retention of title clauses) are not subject to the Ptk. rules on charges and security deposit. I will not deal with the position of retention of title clauses[95] in purchase agreements or outright collateral transfers[96] as securities since the relation between them and the traditional Hungarian *in rem* securitiy devices could be subject to an independent paper and furthermore those concerns do not necessarily peculiar if the securities are used as collaterals. It is interesting, however, that re-characterisation of such transactions as imperfect charges is not subject to detailed analysis in either of the above refered works.

INDIRECT HOLDING SYSTEM

The relevance of the direct and indirect holding of securities have been addressed by the Hungarian legislation in a somewhat confusing way.

The holding of securities issued in (jumbo) certificated form and transfer or creation of (security) interest in such by book entries at the depositary institution (immobilization) is possible[97]. Rights in securities deposited without the possibility of identification of the actual securities belonging to the owners can only be transferred by crediting or debiting the deposit account and can only be pledged by blocking the relevant deposit account[98]. This rules are straight the problem is that they are not harmonized with that of the Ptk. on charges and

[95] See a detailed analysis of retention of title clauses as security devices from ORSOLYA SZEIBERT A tulajdonjog-fenntartás mint hitelbiztosíték (Retention of title as security device) p10 (Polgári jogi kodifikáció 4/2000 p10-21)

[96] A thorough analysis about outright collateral transfers is provided by NORBERT CSIZMADIA Tulajdon mint biztosíték? (Title as security device?) p3 Supra note

[97] Under section 161 of Tpt on the deposit of securities.

[98] See at Tpt Section 166.

security deposit and are not followed by the Tpt as regards dematerialized shares[99]. As we have seen in the American system there should be no difference between dematerialized or immobilized shares the dividing line of the regulation should be whether the securities are held directly or indirectly.

According to the Hungarian regulation, publicly traded securities can only be issued in registered and dematerialized (uncertificated) form (with the exception of treasuries). This and the fact that a dematerialized security can not be issued in certificated form[100] indicate that a trend to complete dematerialization is present in Hungary.

Dematerialized securities are held on securities accounts by "account managers" (banks brokers etc). The Central Account Manager manages central securities accounts for the account managers. The Central Account Manager does not register the name of the beneficial owners only that of the account managers[101]. Accordingly, in Hungary regarding dematerialized shares (and of course regarding immobilized shares) an indirect holding system exists.

The problems of ownership in the indirect holding system seem to be handled in a simple manner. Under the rebuttable presumption of the Tpt[102] the owner of the security in dematerialized form is the person on whose securities account such security is credited and additionally a security in dematerialized form can not be transferred in any way but by crediting and debiting the parties' securities accounts respectively[103].

[99] See at DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS, A zalogjog kezikonyve (The handbook of the law of charge) p348 (HVG ORAC Budapest, 2003)
[100] See section 6 of the Hungarian Act CXX of 2001 on Capital Market (hereto: Tpt")
[101] Section 139 of the Tpt
[102] Section 138 (2) of Tpt. The Act IV of 2006. on corporations contains similar rules on shares in its section 180. § (1).
[103] This is similar to what we have seen at immobilized securities although there the term "ownership" is not mentioned.

The intermediary has no proprietary interest in the securities held on its client account[104]. Therefore, under Hungarian law apparently there is no need for the US term of "security entitlement"[105] since the account holder is treated as owner, who has proprietary rights in the securities held on its account, which thus can not be reached by the securities account managers' creditors[106].

It is questionable how one can be treated as owner in case of commingled central securities accounts and in certain cases without registration in the issuer's books[107]. The theoretical explanation for treating "securities" on a securities account (which under the abovementioned provisions seem to be owned by the account holder) as if the actual securities were deposited at the intermediary on behalf of the account holder (which is if the central accounts are commingled is definitely not the case) is missing. Since the actual securities on the central securities accounts are not held on behalf of the account holders but on behalf of the account manager itself there is no way to separate the actual securities "owned" by each of the account holders. This means that according to the Ptk joint ownership seems to exist[108]. Application of the rules of joint ownership in case of transfer of the securities would be certainly catastrophic. Hungarian lawyers might remain happy even if calling security entitlements to ownership but then the joint nature of such ownership should be recognised and they should never be questioned about the nature of the rights of the intermediary towards the central depositary in case of dematerialized shares.

[104] The system of Belgium or Luxemburg seems to be similar with emphasis on the fact that on the fungible book entry securities of the same type held by the intermediary for all its clients collectively co-ownership right exists. See Explanatory notes p13 Supra note

[105] Or for a term "securities held with an intermediary" that is used by the Hague Securities Convention (Chapter 1 Article 1 1. f))

[106] Tpt section 193. § (1)

107 About the need for rules on the indirect holding of securities see ANDRAS KISFALUDY A Ptk. értékpapírjogi szabályainak koncepciója (The securities conception of the Civil Code) p15 (Polgári jogi kodifikáció Polgári jogi kodifikáció 6/2001 13-16)

[108] Section 134. § (1) *„If the objects of several persons are merged or combined in a way that the separation of such objects may only be accomplished by inflicting substantial damage or unreasonably high cost or if it cannot be accomplished at all; ownership of the final product shall be claimed jointly by the persons affected. If either of the owners should wish not to participate in joint ownership, the person whose thing was more valuable before the combination shall be entitled to choose whether to assume ownership of the thing by recompensing the other owners or to surrender it to them in return for compensation."*

In case of "loss" of the securities held by the account manager - for example if the account manager by breaching its duties transfers securities from its account at the central account holder to another account manager - the distribution of the remaining securities (from the same type) would proved to be problematic[109]. In case of loss of immobilized securities, the deposit account holders will be satisfied according to the proportion of their original deposit[110].

Based on the described characteristics of the Hungarian regulation we can safely assume that the Hungarian regulation embodies most of the risks mentioned by the UNIDROIT drafters.

TYPES OF COLLATERAL (AND POSSIBLE SECURITY DEVICES RESPECTIVELY)

Hungarian law defines the term security ambiguously[111]. One of the two rules (both can be found in Ptk) gives a normative definition[112].the other declares that in order to consider a document to be a security the instrument shall be indicated in an Act of Parliament as such[113] which is clearly a formal approach. Having such rules together is illogical[114].

As discussed above security entitlements (under this name) do not exist in Hungary since the account holders are considered to be the owners of the securities credited on their accounts. The rights of the security account managers *vis-à-vis* the Central Account Manager obviously

[109] Even if according to Tpt 193 (2) in case of the intermediary's insolvency provided that the assets of the intermediary does not cover the claims of its account holders deriving from the securities credited on their accounts enjoy priority.

[110] See at Tpt 162 (2)

[111] The one we can find in the Hague Securities Convention is that *„'securities' means any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein"* (Chapter 1 Article 1. 1.(a))

[112] Section 338/A.(1) describes debt securities as *"A person who makes out (issues) a security on a pecuniary claim shall undertake an unconditional and unilateral obligation that he himself or another person named in the security shall provide a certain sum of money to the security's obligee in exchange for the security."* Additionally section 338/B. (1) regulates securities generally: *"Any claim specified in a security can only be enforced, disposed of, or encumbered by the security and in possession thereof, unless otherwise prescribed by law."*

[113] *Section 338/A.* (2) *"A security is a document bearing the requisites prescribed by legal regulation or data recorded, registered, and forwarded in some other way, as specified by legal regulation, and the printing and issuing of which, or publication in such form, is permitted by legal regulation."*

[114] ANDRÁS KISFALUDY p13 Supra note

can not be described by the term ownership and seem not to be described in any other way therefore may be of contractual nature (which is logical *non-sense*).

There is no special provision on charges encumbering securities accounts[115]. It is obvious that the securities account itself is something without value, however, the securities credited on such account from time to time are assets that can be used as collaterals. When we say creating a charge on a securities account, we mean creating a charge on a changing pool of assets e.g. on the securities credited both in the present and in the future on such account. This phenomenon resembles to the floating lien concept in the U.S. or the English floating charge.

The more or less equvivalent term for "investment property" in Hungarian law is "investment device[116]" the scope of which seems to be similar to the scope of the term "security" under the European Collateral Directive.

As indicated above different types of collaterals can be subject to different kind of security interest therefore we need to analyze whether the rules of the two types of charge and the security deposit can be applied to securities.

The Financial Collateral Directive was implemented to the Hungarian law by modifications of the rules on security deposit. Security deposit is based on possession or control of the collateral (that can only be cash or securities). The relation between security deposit and charge is mysterious. The parallel existence of the two raises questions such as if security deposit is a type of charge or not and whether for example financial collater can be subject to charge (especially charge requiring possession) or only to security deposit. Since the rules on enforcement significantly differs in case of possessory charges and security deposit the characterization of the parties' agreement may have crucial importance.

[115] That is defined by the Hague Securities Convention as an *„account maintained by an intermediary to which securities may be credited or debited"* (Article 1. 1. b))

[116] "Befektetési eszköz" as defined in Tpt 82 § See GÁRDOS, BENKE, MOSONYI, TOMORI ÜGYVÉDI IRODA Pénzügyi biztosítékok (Financial collateral) 2.1 at http://www.gfmt .hu/hu/kiadvany_11.html (30 March 2007)

There are different answers for the above questions[117]. The basic rule is that either personal property or rights can be charged[118], therefore regardless what we mean by "securities" (they may be considered as things if they are certificated or as claims (rights) against the issuer or the securities intermediary in case of a securities account) they can be charged.

The real question is how. The first type of charge, which requires possession[119] by the creditor (and is not subject to registration) is certainly applicable to certificated securities.

Most probably if the dematerialized shares are credited on the securities account of the creditor he can be considered as someone who possesses such shares although possession is a term that reflects to phisycal objects. More problematic is the possession by the creditor (or the debtor) of securities held on a sub-account as we will see below.

Enforceability of these is most probable since the possessor of a share or an account holder on whose account the security is credited is presumpted to be the owner of the share.

In case of certificated promissory notes there is a possibility to indicate in the endorsement on the certificate that the note has only transferred for collateral purposes[120], which is the clearest solution possible, the only problem is that this rule has a limited scope and as discussed under the American history of holding securities transferring the possession of endorsed certificates is not the normal way of dealing with securities on modern capital markets. Additionally possession of promissory notes and other securities in certified form can be transferered without any endorsement or with endorsement sufficient to transfer of title the formal obviously serves the interests of the debtor the latter that of the creditor[121].

[117] See DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS p336 Supra note

[118] See at Ptk 252. § (1) *"A charge may be put on all things which are capable of appropriation and on any transferable right or claim"*.

[119] Ptk. 265. § (1) *"To create a possessory charge, it shall be necessary to conclude a charge contract and to surrender the pledged property. Such property may also be delivered into the hands of a third person (pledge holder). In commercial circulation, charges can be acquired in good faith even if the person providing the pledged property is not the owner"*.

[120] Article 19, Decree 1 of 1965. on the publication of the Convention concluded on 7 June 1965 on the law of promissory notes (Valtorendelet, 1965. évi 1. törvényerejű rendelet a Genfben, 1930. június 7-én megkötött váltójogi egyezmények kihirdetéséről)

[121] See DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS p337 Supra note

The other type of charge (where the method of perfection is registration instead of possession) is more problematic. There is no doubt that by this we can collateralize certificated securities, and probably also securities on a securities account[122].

Securities on a securities account if they are used as collaterals supposed to be credited on a depositary sub-account by the account manager[123]. It is questionable whether this act creates or perfects the charge, probably neither and shall only be considered as an administrative burden on the account manager[124] (it is actually not true in case of deposited (immobilized) securities where blocking the deposit account is the only way to create any kind of encumberence[125]).

However, since even in case of dematerialized shares the debtor can no longer use freely its securities deposited on the sub-account its position as possessor is fading. The question is then whether this is supposed to be a possessory or a non-possessory charge. The answer will determine whether there is a need for registration for perfection.

The fact that the securities held on securities account shall be held on sub-account if they are encumbered by (any type of) charge may lead[126] to the conclusion that non-possessory charge on securities held on a securities account is finally impossible[127] if each person involved fulfills its legal obligations.

On the other hand in case of charge requiring possession the role of the sub-account is again problematic. The question here is whether the creditor has possession or not. If not (and has only if the securities are credited its own account) the charge is not perfected until the

[122] 262. § (2) *"For the creation of a charge on other things, the charge contract shall, unless otherwise provided by legal regulation, be documented in front of a notary public, and the charge shall be recorded in the register maintained by the Hungarian Association of Notaries Public (charge register) in accordance with the provisions of a separate law. If a lien is put on several properties, or if the pledged property cannot be labeled in itself, the pledged property or the group of properties may be described by type and quantity or by elaborate description."*

[123] Tpt 144. § (1)

[124] See DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS p345 Supra note

[125] See DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS p348 Supra note

[126] And must lead in case of immobilized securities.

[127] See the reference of DR. ANKA TIBOR, DR. GARDOS ISTVAN, DR. NEMES ANDRAS to SALAMONNE DR SOLYMOSI IBOLYA p336 Supra note

securities are "only" on the sub-account, which would give no sense to the existence of the sub-account.

Without possession (at least on the sub-account in case of dematerialized securities or at least without endorsement in case of certificated securities) a charge on securities seems to be a weak security device[128]. The reason derives from the legal nature of securities namely from the fact that adverse claims are as a general rule excluded in case of a security transfer. The right to the security is embodied in the certificate or in the securities account. Therefore, a debtor who has possession (notwithstanding the limited possession on the sub-account) can more or less freely transfer title of the security and terminate the encumbering charge thereby[129].

This is the reason why the preferred security device if the collateral is a security will certainly be those that implies possession of the security by the creditor (possessory-charge and security deposit).

The fact that possession[130] and title can hardly be separated from each other if securities are concerned triggers the trend that charges encumbering securities are transforming into outright title transfers. This is clearly not an important issue in the US where the conceptual differences are of no relevance in the field of secured transactions.

ATTACHMENT AND PERFECTION

These two terms are not used by the Hungarian legislation although the concept clearly exists as far as by attachment we mean the conclusion of a valid contract regarding the creation of

[128] Probably the drafters of UCC recognized this when ranking security interests perfected by filing prior to security interests perfected by control.

[129] According to Section 47. (1) of Ptké. (Decree 11 of 1960 on the commencement and execution of the Hungarian Civil Code) entries in the charge register maintained under Section 262 (2) of Ptk (See above) have constitutive effect, although the fact that a third party who gains rights in the pledged security could have known the existence of the charge from the register does not make such person considered to be acting in bad faith.

[130] or control as far as the system of UCC, or the Hungarian rules on security deposit are concerned.

the security interest (charge[131]) and by perfection[132] the act through which third parties can be informed about the asset being collateralized[133].

Neither of the two types of acknowledged security devices seems to be valid against third parties if none of the methods of perfection (transfer of possession - control in case of security deposit - or registration) is applied.

As mentioned above the Hungarian charge has two basic types: one needs possession of the collateral by the creditor (the closest term from the Anglo-Saxon law is pledge) the other does not (which could be characterized as (chattel or real property) mortgage although the great difference between the common law and the civil law mortgage is that there is no transfer of title in case of the civil law mortgage[134]. Probably the term "equitable mortgage" known by English law is closest to what we may call in the civil law "mortgage".

Therefore, the methods of perfection of a charge are the following in Hungary: if the collateral is a real estate: registration, if the collateral is personal property: registration or transfer of possession according to the parties' intention.

Perfection of a security deposit needs transfer of possession or control[135].

Outright collateral transfers (that shall be acknowledged as possible methods of providing securites as collaterals) are out of the scope of the Ptk. rules on charge and security deposit therefore registration is obviously not required (and is not possible either) therefore the risk of recharachterisation can not be totally excluded although there is no such precedent. In case of securities this issue seems not to be crucial since (also) the (collateral) transfer of title requires

[131] Ptk Section 254. (1) *"Charges are created under contract or pursuant to legal regulations and on the basis of court and, if so prescribed by law, other official decisions." The formal requirement set by the Ptk itself is that the agreement shall be concluded in writing, however under Ptk. Other legal regulation can set further formal requirements*".

[132] Perfection is defined in the Hague Securities Convention as *"completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition*" (Article 1 Chapter 1 1.i).

[133] About problems of non-perfected but attached security interests under Hungarian law see TIBOR TAJTI, Supra note 307. TAJTI reveals no solution – since probably there is no solution – and refers the problem to the courts.

[134] See TIBOR TAJTI p86 Supra note

[135] Ptk. Section 270. (1.)

having possession of the certificate (with the necessary endorsement) or being the share credited on the creditor's securities account.

Therefore, as it was mentioned above it is hard to differentiate between an outright collateral transfer and a security deposit if the parties do not give straight name to their transaction. Fortunately, the consequences of the two are more or less the same since in case of insolvency creditors secured by collateral provided as security deposit has a preferential status[136] as we will see below among the rules of enforcement.

PRIORITY

In case of the debtor's insolvency claims secured by charges can be settled after the reimbursement of the costs of the custody, preservation and sale of the collateral and the liquidator's fee[137].

Creditors secured by security deposit can be satisfied from the collateral regardless the commencement of the insolvency procedure[138].

If the same asset is encumbered by charge the security interests rank according to the date of their creation[139].

The Ptk does not clarify priority rules between security deposit and charge created on the same collateral[140].

Transferring collateral previously made subject to non-possessory charge as security deposit (which in case of uncertificated securities is only possible if the account manager does not

[136] Cstv. 38. § (5)

[137] Cstv. 49/D. § (1). Unfortunately the liquidator's fee includes certain costs of the liquidator and is calculated on the basis of the value of the whole liquidation which can jeopardize the satisfaction of even the secured creditors.

[138] Cstv. 38. § (5)

[139] Ptk. 256. § (1) *"If the same pledged property is encumbered by more than one charge, the charge holders shall, unless otherwise provided by law, be satisfied in the order in which the charges were created (order of priority)"*.

[140] Priority rules could be developped either by creating a list with all possible conflicts and settle them individually or creating universal rules (Firstly by the acknowledgment that securitiy deposit is a type of charge). In the latter case the rules of UCC could be followed since Hungarian law practically applies the same methods os perfection.

fulfill its obligations regarding the sub-account) would probably terminate the non-possessory charge if such collateral were a security[141]. The transfer is hardly possible or at least probable in case of an earlier made possessory charge.

Creation of non-possessory charge on an asset earlier provided as security deposit would probably not terminate the security deposit based on the *nemo plus iuris* rule and the fact that the actual delivery or transfer of the collateral can not be effected without the consent of the bona fidei security deposit holder (who additionally has his securitiy interest perfected earlier).

PROCEEDS

Generally, the security interest in an asset covers its proceeds as well, however the parties can exclude the applicability of this[142].

In case of security deposit the rule is that in the lack of the parties agreement the creditor is not entitled to use the collateral.[143]

ENFORCEMENT

Probably the weakest element of the Hungarian system of charges is that the direct enforcement of the creditor's claim is strictly limited. The involvement of the court is generally necessary which means that the enforcement procedure tends to be endless[144].

[141] The reason might be Ptk. 338/B (1) cited above or by analogy Ptk 262. § (6): *"A charge registered in the charge register shall be terminated if the pledged property is sold in commercial circulation or under normal measures to a bona fide buyer. It shall also be terminated if such bona fide buyer acquires, for consideration, ownership of a thing generally used for everyday needs"*.

[142] Ptk. 252. § ((2) (2) "*If so agreed by the parties, a charge can also be put on the proceeds from the pledged property. If, however, the pledged property is not held by the lien holder, the pledge shall not include any separated proceeds, unless the pledged property had previously been placed under attachment*".

[143] Ptk. 270. § (3) "*Parties may agree to grant the right of the collateral taker to use and dispose of the financial collateral as the owner. Where a collateral taker exercises a right of use, he thereby incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations covered by the financial collateral arrangement. The equivalent collateral shall replace the original financial collateral.*

[144] Ptk. Section 255. (1) "*Unless otherwise provided by law, satisfaction from the pledged property shall take place on the basis of court order by a writ of execution*".

In case of security deposit there are more creditor friendly rules (as prescribed by the Financial Collateral Directive), which means that the creditor in certain cases is entitled to satisfy its claim from the asset held in his security deposit[145]. Although if the value of the asset cannot be evaluated on objective criteria the direct right to satisfy the creditor's claim only applies if the parties initially agreed accordingly (such agreement needs to contain the method of sale).

(2) "*Agreements that are concluded before the claim is due and grant the lien holder the right to acquire ownership of the pledged property in the event of the failure to fulfill the obligation shall be null and void".*
Section 257.
"(1) The parties can agree in writing to sell the pledged property together before the claim to which it pertains falls due by establishing the lowest sale price or a formula for calculating the sale price, and a deadline from the date on which the claim falls due. If the pledged property cannot be sold before the deadline and/or under the conditions set forth in the agreement, the agreement for joint sale shall become inoperative.

[145] *Section 271.*
"(1) Upon the due date for the performance of the relevant financial obligations the collateral taker shall be able to realize the financial collateral if it is cash, money on account, security or other financial instrument whose market price is listed publicly or can be determined at that time independent from the parties. The collateral taker shall be able to realize the financial collateral provided in other forms of security or financial instruments if the parties have so agreed in the financial collateral arrangement and have stipulated the method of valuation of the financial instruments.
(2) If the financial collateral arrangement contains an agreement for the valuation of the securities and other financial instruments, sale and appropriation shall be subject to the terms of the financial collateral arrangement.

CONCLUSION

WE HAVE EVERYTHING THEN WHY IS IT INCOMPRIHANSIBLE?

As the reader has probably noticed, the Hungarian legislation regarding the usage of securities as collaterals embodies all the building blocks of the effective and clear systems either if we use the UNIDROIT draft convention or the more detailed UCC Article 8 and 9 as model. Furthermore, our rules on security deposit contain all the building blocks of the Financial Collateral Directive.

The only problem is that we have not built a building from the blocks yet.

For example if we have effective rules (such as those regarding enforcement in case of a security deposit) we cannot be sure when we can use them (in case of possessory-charge on securities?). On the other hand, if we find clear rules (like those about charging and transfer of immobilized securities) we may happen to find other rules that regulate the same collateral differently (general rules on creation of charges).

In addition we cannot understand and therefore apply our codes without understanding the underlying theories and history of foreign legislations or harmonization efforts (such as the US or UNIDROIT). But our task may be even harder after reading the first two chapters of this work since we find things what seemed to be logically attached abroad separated from each other either physically or theoretically (dematerialization, immobilization) in Hungary because they were inserted among the traditional rules following different logic.

THEN WHAT FOLLOWS?

Most probably, I cannot give a better-focused description than the one provided by Csizmadia Norbert[146].

[146] See NORBERT CSIZMADIA A tőkepiaci értékpapírok "tulajdona" átruházása és megterhelése ("Ownership" transfer and charge of capital market securities) p40 Supra note

What has to be noted is that the principles of the new Hungarian securities regulation (including the creation of security interest) need to follow the guidelines provided by the UCC and the UNIDROIT draft convention.

I believe that the most important task is to create a coherent system from the scattered provisions we already have and to find a proper translation for “security entitlement” since the pool of in rem and in personam rights that account holders (and intermediaries) have against the relevant intermediary does not fit into the categories of the now used “ownership” and “deposit”.

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