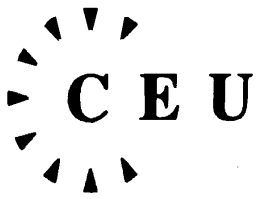

INVESTMENT PROPERTY AS COLLATERAL: BASIC DIFFERENCES BETWEEN CZECH AND US LAW

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TABLE OF CONTENTS

ABSTRACT

This thesis investigates the use of investment property as collateral in the direct and indirect securities holding systems.

This thesis shows shift from direct holding system towards indirect holding system of securities in US and direct holding system in the Czech Republic. The thesis furthermore discusses the creation, perfection and enforcement of the security interest in investment property governed by Article 9 UCC and compares it with the relevant regulations in the Czech Republic. The differences in both legal systems are assessed with regard to what lessons could be learned from Article 9 UCC solution.

Some aspects related to the investment property collateral inherent in US law of secured transactions for example, the priority rules and possible tolerance to the secret lien are also examined. Additionally, special attention is devoted to recent implementation of the financial collateral to the Czech legal system in compliance with the Financial Collateral Directive.

LIST OF ABBREVIATIONS

Article 8	Article 8 of the Uniform Commercial Code of the United States
Article 9	Article 9 of the Uniform Commercial Code of the United States
Capital Market Undertakings Act	Act No. 256/2004 Coll. on Business Activities on the Capital Market
	The Prague Securities Centre
Centre	The Prague Securities Centre
Civil Code	Act No. 40/1964 Coll., as amended, Civil Code
ComC	Act No. 513/1991 Coll., Commercial Code, as amended
DTC	Depository Trust Company
Financial Collateral Directive	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
Operational Rules	Operational Rules of the Prague Securities Centre
Securities Act	Act No. 591/1992 Coll., on Securities, as amended
UCC	The Uniform Commercial Code of the United States
US	The United States of America

1. INTRODUCTION

Modern trade relies on access to credit. According to Daniel Webster, credit is "the vital air of the system of modern commerce. It has done more, a thousand times, to enrich nations, than all the mines of all the world."[1] The US quickly realized that economic growth depends on strong secured transactions. It adopted Article 9 of the Uniform Commercial Code, which is a set of model laws that implement a comprehensive system of security interests. Article 9 has been successful because it reflects market changes and responds with pragmatic revisions to the existing rules. This is important because successful investment property regulation greatly relies on the ability to adapt to change.

The use of investment property as collateral is closely related to financial markets. The structure of financial markets in the past two decades has changed fundamentally. In the United States most securities are not held by individual investors with direct relationships to the issuers. Rather, they are held by chains of intermediaries such as banks or brokers. Due to advances in technology, trade occurs through simple electronic entries on securities accounts held by intermediaries. Moreover, the securities are held on a pooled and unallocated basis without the possibility of identification of individual investors. The new form of securities and the emergence of indirectly held securities conflict with traditional property law concepts assuming creation of security interests by physical delivery of certificate or registration on books of issuer. This does not occur in the indirect holding system. The UCC uniquely addressed this issue; it implemented a *sui generis* right which comprises both property and personal interests. This enables the creation, perfection and enforcement of security interests in the investment property collateral comprising of indirectly held securities.

[1] *See* DANIEL WEBSTER, SPEECHES AND FORENSIC ARGUMENTS (Tappan, Whittemore, and Mason, 1848), at 235. Senator Daniel Webster held this speech in the Senate of the United States in favor of continuing the charter of the Bank of the United States, March 18, 1834.

In contrast, the capital market in the Czech Republic has a different structure. Currently, the Czech Republic only practices the direct holding of securities although the two-tiered system is envisaged by the Capital Market Undertakings Act[2]. The vast majority of securities in the Czech Republic exist in dematerialized form registered with the Prague Securities Centre. This system suffers from deficiencies regarding, *inter alia*, the use of securities as collateral. Thus, the success of the new system will greatly depend on legislation implementing the Capital Market Undertakings Act. The conception of control over pledged securities in UCC Article 9 should serve as inspiration for the new Czech system.

It is not possible to answer any questions related to the rights of the parties to a security interest in investment property without understanding how the securities are traded. First, this thesis will demonstrate the move towards the indirect holding system in the United States and the direct holding system in the Czech Republic.

The thesis aims to show the differences in the Czech and US approach to the security interest in the investment property collateral; for example, the conception of control, the enforcement of the security interest and the possibility to create security interest in same securities for more creditors. Moreover, special attention will be paid to the conception of property rights in the indirectly held securities under the UCC because if the multi-tiered system is introduced in the Czech Republic it could serve as inspiration. Also, similarities will be pointed out, for instance in both systems before the *erga omnes* enforceable security interest is created the public must be notified about the creation of security interest.

The topic of the thesis is very complex. The goal is not to tackle the entire subject, but rather to concentrate on particular specialized issues related to the investment property

[2] Zákon č. 256/2004 Sb., o podnikání na kapitálovém trhu [Act No. 256/2004 Coll., as amended, on Business Activities on the Capital Market] of 14 April 2004. The act entered onto force on 1 May 2004. Registration of investment instruments and provisions on central depository on securities are governed by Part Seven of the act.

serving as the collateral; for example, priority of the secured creditor over entitlement holder, issue of the potential tolerance to the secret lien and implementation of the financial collateral to the Czech law. The aim of this thesis is not to analyze in detail the regulations regarding the use of securities as collateral that currently exists in the Capital Market Undertakings Act. Such analysis has no deeper relevance because the system of indirectly held securities is not yet in practice and potential problems might be solved by implementing regulation. Instead, this thesis offers solutions implemented by Article 9 UCC from which the Czech law could benefit.

The topic was examined from its own perspective which means that sometimes the exact counterpart does not exist in the other country's law. Even the Czech Republic itself does not have single set of terms for security interest or types of securities. Czech law does not have equivalent terms for "security entitlement" or "securities account" which are involved in broader term "investment property". Thus, when referring to "investment property", the Czech counterpart refers to "securities". Similarly, the concept of "financial collateral" in the Czech law could be most accurately compared to "financial assets" under Article 8. The *in rem* right which the creditor has in the collateral is referred to as the "security interest" when related to Article 9 and as the "pledge" in Czech law. It is assumed that for the purposes of this thesis security interests include only consensual interests and the security interest was examined mostly with regard to the securities traded on capital markets.

Legal literature, statutes, cases and internet sources were used for this thesis. The existing literature relating to transactions secured by investment property is sufficient. However, most of the literature limits the scope of the analysis to Article 9 and the relevant parts of Article 8, without comparison with foreign solutions to the problem. However, great comparative work regarding property interests in securities is Erica Johansson's Property Rights in Investment Securities and the Doctrine of Specificity whose subject matter is the

doctrine of specificity and its non-compliance with development in the financial markets. The comparative analysis on use of securities as collateral under Czech law and US law is missing. In Czech literature several authors comment on the pledge of the securities bringing out interesting problems from practice – e.g. Tomáš Richter, One Flight over Czech Security Interests: Priorities and other Monsters of Post-Transformation Debtor/Creditor Law and with regard to financial collateral - Tomáš Sedláček, Lukáš Strnad, Closer to the Purpose of Financial Collateral.

2. THE UNITED STATES

It is apparent that when it comes to secured transactions law, the US has left other countries behind. The US promptly recognized the importance of credit and reacted by the implementing a comprehensive, pragmatic and uncluttered system of security interests regulated in Article 9 UCC. The framework of rules for the attachment, perfection, priority and enforcement of security interests was flexible enough to adjust to the development of a system of securities held not directly by investors in their safes but by intermediaries (i.e. most often through brokers or banks).

The thesis shows how the shift on financial markets towards indirectly held securities existing mostly only as electronic records was implemented legally in Articles 8 and 9. Furthermore, I will demonstrate how Article 9 uniquely solved non-conformity of securities evidenced only in book-entry form held through chains of intermediaries with traditional property law rules based on tangible assets. I will also show how Article 9 provides a simple mechanism for the creation and perfection of security interests, effective enforcement methods and clear priority rules between conflicting security interests for both directly and indirectly held securities.

2.1 General remarks

2.1.1 Article 9 UCC comprehensive and unitary solution

If there is one underlying conception of Article 9 that shall be mentioned, it is the functional approach[3] to personal property security devices. Article 9 applies complex and

[3] *See* UCC s. 9-109(1). For further information on implementation of functional approach to Article 9 UCC s*ee* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (Little & Brown, Boston &Toronto, reprinted in 1999 by The Lawbook Exchange, Ltd. New Jersey), at 295 et seq. The functional approach is based on presumption that all security transactions satisfy same economic objectives and therefore shall be governed by the same legal framework regardless of their form. It follows that not only traditional charges but also all transactions with same effect fall within the scope of Article 9. The functional approach can be contrasted to

uniform solutions for the regulation of security interests in personal property and fixtures, while at the same time considering the specific characteristics of individual categories of personal property.[4] Article 9 "attempts to apply similar rules to all transactions that in economic terms are intended to serve as security."[5] This solution accommodates business practice by enhancing legal certainty of secured transactions' participants - secured transactions regime of Article 9 is applicable to their transaction even if one party retains the title to the collateral but does so to secure monetary claim (e.g. retention of title, financing leasing). Similarly, the drafters of Article 9 UCC anticipated the needs of commercial reality, seeking extension of assets available for security purposes. Thus, in correlation with the revised Article 8 UCC, the 1994 amendments to Article 9 created a completely new class of personal property collateral called "investment property".[6] The purpose behind these policy choices is readily determined – to promote commercial practices through creation of credit friendly environment.

2.1.2 What is investment property?

The correct classification of collateral is of imminent importance for purposes of attachment and perfection of security interest; therefore certain terminology facilitating the understanding of what is covered by investment property collateral shall be addressed first.

UCC Article 8 concerns investment securities both in indirect and direct holding systems, while Article 9 governs rules on security interests in investment securities.[7] The distinction is made between securities and investment property in order to govern both by

formalistic approach followed in e.g. Czech law where transactions intended to serve same economic functions are regulated by different rules leading to *numerus clausus* of security devices.

[4] *See* TIBOR TAJTI, COMPARATIVE SECURED TRANSACTIONS LAW, (Akadémiai Kiadó, 2002), at 142.

[5] *See* GERARD MCCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW (Cambridge University Press, 2004), at 1.

[6] *See* Douglas R. Heidenreich, *Article eight – article eight?*, 1996, 22 Wm. Mitchell L. Rev. 985, at 997.

[7] *See* ERICA JOHANSSON, PROPERTY RIGHTS IN INVESTMENT SECURITIES AND THE DOCTRINE OF SPECIFICITY (Springer, 2008), at 139.

independent rules. Thus, the term investment property refers to "(a) security[8], whether certificated (represented by an instrument either in bearer form or registered form) or uncertificated, (b) security entitlements[9], (c) securities accounts,[10] (d) commodity contracts and (e) commodity accounts."[11] The use of commodity contracts and commodity accounts in secured transactions is less common and beyond the scope of this thesis. Therefore, when referring to "investment property" what is meant is "securities" (e.g. stocks, bonds), "security entitlement" or "securities account".

2.2 Article 8 and 9 revised for modern ages

2.2.1 Swift development in the capital markets

2.2.1.1 Uncertificated securities

Until recently, securities in all jurisdictions around the world were in written or printed forms. The owner of securities held securities himself and trades were carried on by physical

[8] *See* UCC s. 8-102(a)(15) explains that "security" includes "an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:
(i) which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;
(ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and
(iii) which:
(A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or
(B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article."

[9] The "security entitlement" is defined in UCC s. 8-102(a)(17) as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5." Part 5 of Article 8 UCC implemented an indirect holding system for investment securities.

[10] *See* UCC s. 8-501(a) according to which "securities account" means "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."
"Financial assets" according to UCC s. 8-102(a)(9) refers to "(a) securities, (b) obligations of a person or a share, participation or other interest in a person, property or an enterprise of a person which is, or is of a type, dealt in or traded on a financial market or which is recognized as a medium for investment and (c) any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under Article 8 UCC."
It follows that the definition of financial assets is much broader than the definition of securities.

[11] *See* UCC s. 9-102(49).

deliveries of certificates from the seller to the purchaser and possibly even issuer if the securities were registered.[12] Obviously the sale and purchase of securities did not essentially deviate from the transfer of any other personal property, although other personal properties were not usually traded in such an amount.

The sharp increase in trading volumes caused "mechanical problems of processing the paperwork for securities transfers" which led to "paperwork crunch" in New York Stock Exchange in the 1960's. A modern system of electronically recorded ownership and transfer of securities by entries in register of issuer followed.[13] Advances in computer technology enabled computerization (immobilization and dematerialization)[14] of the securities market and facilitation of trade settlement which all together caused a shift from a system of direct holdings towards more efficient system of holding securities through "multi-tiered pyramid" of intermediaries.[15] However, it does seem that the comparison of the whole system to pyramid is too excessive, but I will show that it is more or less accurate.

2.2.1.2 Indirectly held securities

In an indirect holdings scheme tiers of intermediaries are inserted between issuer and the ultimate investor. The interest of investor is recorded on the books of the account administered by first-tier intermediary together with the interests of other clients. This intermediary in turn has his interest registered in its name without identification of his individual clients on the books of the account maintained by upper-tier intermediary. This

[12] *See* UNIFORM COMMERCIAL CODE, Prefatory Note to Revised (1994) Article 8,1 cited in WILLIAM D. WARREN, STEVEN D.WALT, SECURED TRANSACTIONS IN PERSONAL PROPERTY (Foundation Press, 2007), at 407-8.
[13] *See id.*, at 408.
[14] Dematerialized securities exist only in form of book entries on accounts. Immobilised securities are certificated or bearer securities often issued in jumbo or global format deposited in custody. Immobilised securities are held indirectly through multiply tiers of intermediaries whereas dematerialized securities can be held also directly.
[15] *See* JOHANSSON, *supra note* 7, at 40-42.

way it continues by building multi-tiered holding structure consisting of a chain of intermediaries replicated over and over again.[16]

It seems that the indirect holding system cannot exist without the direct holding system. The entity on the top of the chain – the Depository Trust Company of New York („DTC")[17] – has an unavoidably direct relationship with the issuer, and it is Cede Co. (nominee name used by DTC) who either is recorded in the books of the issuer as an owner or possesses immobilized security certificate.[18] By holding all securities with DTC all transfers can be executed as adjustments to securities accounts of DTC[19] participants (i.e. intermediaries) without burden of physical deliveries.[20] Centralized clearance and settlement is provided by National Securities Clearing Corporation.[21] In other words, the initial investor is not recorded on the books of issuer, neither has he possession of the physical certificate as in the direct holding system. Instead, the interest in securities issued by the issuer is "intermediated" through chain of banks or brokers. Indeed, the fact that the investor and the issuer are not in the direct relationship can be seen as fundamental difference from the direct holding system.

So now we can imagine the multi-tiered pyramid. The initial investors are at the basis, the intermediaries are in the middle and on the top is DTC where securities are immobilized.

[16] *See* JOHANSSON, *supra note* 7, 43-45, *see* JAMES STEVEN ROGERS, CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 1 (International Monetary Fund, 1999), at 265.
[17] *See* https://portal.dtcc.com/dtcorg/
[18] *See* UNIFORM COMMERCIAL CODE cited in WARREN & WALT, *supra note* 12, at 409.
[19] According to its webpage, in 2007, DTC settled transactions worth $513 trillion, and processed 325 million book-entry deliveries.
[20] *See* UNIFORM COMMERCIAL CODE cited in WARREN & WALT, *supra note* 12, at 409.
[21] *See* http://www.nscc.com/

2.2.2 1978 amendments to Article 8 UCC

Drafters of the UCC reacted on already longer time lasting practice of indirectly held securities by 1978´s amendments to Article 8 which supplemented existing rules on certificated securities with parallel rules governing uncertificated securities. It follows that only improvement was that transfer of securities could be made by record in the issuer´s register.[22] As Schroeder[23] notes "it implicitly presume[d] that the paradigm of property interests in personality is the actual sensuous grasp of a physical object in one´s hand in such fashion that it can be seen by, and wielded against, others."[24] That suggests that the nature of indirectly held securities was not adequately legally understood as it seems clear that "set of rules for "certificated securities" and another set of rules for "uncertificated securities""[25] cannot sufficiently reflect specific characteristics of indirect holding system. Indeed, traditional property law conception assuming that security interest in the particular securities is created either by delivery of the certificate or by registering on issuer´s books worked perfectly in direct holding system.[26] Nevertheless, in the indirect holding system the same rules cannot apply because neither of these events ever occur.

The drafters of UCC answered critical voices seventeen years later by implementing new independent legal rules regarding the indirect holding system in what is known as the "Revised Article 8" and the "Revised Article 9".

[22] *See* UNIFORM COMMERCIAL CODE cited in WARREN & WALT, *supra note* 12, at 408.
[23] Jeanne L. Schroeder is a Professor of Law at the Benjamin N. Cardozo School of Law at Yeshiva University in New York City. Her scholarly interests covers commercial law doctrine and securities regulation with special attention given to Article 8 UCC.
[24] *See* Jeanne L. Schroeder, *Is Article 8 finally ready this time? The Radical Reform of Secured Lending on Wall Street*, 1994, COLUM. BUS. L. REV. 291, at 303. *See also* James S. Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 1996, 43 UCLA L. REV. 1431, at 1435-37, 1453-56. Professor Rogers from Boston College Law School was engaged as Reporter to the Drafting Committee responsible for the 1994 revision of Article 8.
[25] *See* James S. Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 1996, 43 UCLA L. REV. 1431, at 1454.
[26] *See* JAMES STEVEN ROGERS, CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 1 (International Monetary Fund 1999), at 265.

2.2.3 Articles 8 and 9 revised for modern ages

The revision of Article 8 brought new provisions governing exclusively only the indirect holding system whereas the rules relating to the creation and the enforcement of the rights of the parties to a security interests were moved to Article 9.[27]

The most important aspect of the revision was its recognition that traditional conception of property law was somehow overgrown by the indirect holding system and therefore different approach to rights related to securities is needed. The owner of the security was not perceived as purchaser of the "specific quantity" of securities and neither was he seen as the holder of it anymore.[28] Instead, the new system took a completely new approach towards rights in securities held through intermediaries.

The system of indirectly held securities brought benefits to capital market participants because it "reduce[d] costs and complexities of record-keeping and lower[d] the risk of looses caused by physical transfer of securities."[29] On the other hand, from the legal perspective securities evidenced by electronic entries on securities accounts maintained by intermediaries increased legal uncertainty about rights and duties of the parties because of the impossibility of applying traditional legal concepts of property law. The next chapter discusses a solution in Articles 8 and 9.

2.2.4 The US solution to the property rights problem

In general, the creation of a security interest requires the indication of property which is intended to serve as collateral. The legal rules thus anticipate that each asset can be

[27] *See* Heidenreich, *supra note* 6, at 988.
[28] *See* Heidenreich, *supra note* 6, at 993-94.
[29] *See* Steven L. Schwarz, *Indirectly Held Securities and Intermediary Risk* (2002-01) UNIFORM L REV (revue de droit unifome) cited in JOHANSSON, *supra note* 7, at 41.

separated from other assets and sufficiently identified. Contrary to this presumption, the indirectly held securities existing only in computer records remind more ”melting pot” of securities “owned” by brokers´ clients and by brokers itself. And as Johansson[30] concisely notes, “[i]n comparison with grain in a silo or oil in a tank they cannot be separated as they do not exist in the physical world.”[31]

The brokers´ books show only that he has a certain amount of securities of certain type deposited but these securities are held on „ a pooled and unallocated basis.“[32] In other words, how many securities belong to private investor, other client or intermediary itself is showed only in the registry of the relevant intermediary. Therefore investors rights (payment of dividends, transfer of position to another investment firm) cannot be connected to any specific “pools of individual fungible”[33] securities held on the securities account of intermediary. Instead it is “package of rights and interests“[34] connected to security transferable between individual participants of multi-tiered structure – in the words of Article 8 UCC – security entitlement. The investor (entitlement holder) possesses these rights only against his own intermediary who maintains record of his interests based on the direct contractual relationship between them not against the issuer or any other intermediaries which are part of the chain.[35]

[30] Erica Johansson is a leading expert in the area of intermediated securities and has also acted as a legal consultant to the World Bank. Johansson is known mainly as author of comparative book called “Property Rights in Investment Securities and the Dosctrine of Specificity”.
[31] *See* JOHANSSON, *supra note* 7, at 45.
[32] *See* JOHANSSON, *supra note* 7, at 2.
[33] *See* HANS VAN HOUTTE, THE LAW OF CROSS-BORDER SECURITIES TRANSACTIONS (Sweet & Maxwell, 1999), at 59.
[34] Professor James Steven Rogers described “security entitlement” in the following terms: ”A security entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's securities intermediary and its property. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system. Rather, the fundamental principles of the indirect holding system rules are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the security, and therefore, that an entitlement holder can look only to that intermediary for performance of the obligations.“ *See* James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 U.C.L.A. L. Rev. (1996) 1431, at 1456-57.
[35] *See* ROYSTON M. GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY (Sweet & Maxwell, 2003), at 215. James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 U.C.L.A. L. Rev. (1996) 1431, at 1456-57.

By introduction of a security entitlement as a "*sui generis* interest representing both personal and property rights in the underlying pool of assets"[36] involving *in rem* right of the investor against "property" of the intermediary and also contractual rights of the investor against intermediary Article 9 UCC departed from the traditional conception of security interest as solely property right. Thus it comprises a right which is enforceable not only contractually between parties but as *in rem* right also against any other person. The UCC thus elegantly solved the requirement for identity of assets in order to have a protected property right.[37] For simplification of creation of a security interest to whole account maintained by intermediary for the entitlement holder Article 9 included term securities account.[38] That new device enabled the debtor to confer security interests not only in particular security entitlement but also in an entire securities account.

The introduction of the security entitlement´s notion is of crucial significance for secured transactions. Earlier regulation did not take into account the real essence of the transaction – the creation of the security interest. Instead, it was based on the presumption that a pledge requires physical possession. Such conceptual structure could be embodied to the modern multi-tiered system only by way of viewing the creditor as having actual "possession" of a security when the intermediary had agreed to follow his instructions. New regulation prevents any confusion between the "possessor" and the secured creditor caused by "forcing these arrangements into the Procrustean bed of fictitious possession of securities" held through system of indirect holding. Instead, Articles 8 and 9 perceive "pledge" of securities in system of indirect holdings as creation of a security interest in a securities entitlement. [39] That suggests that rather than introduction of new concept of property rights the new

[36] *See* JOHANSSON, *supra note 7*, at 52.
[37] *See* JOHANSSON, *supra note 7*, at 3, 160, 163-65.
[38] *See* Ali Report Art. 8,9 cited in JOHANSSON, *supra note 7*, at 143.
[39] *See* ROGERS, *supra note* 26, at 269.

approach to property rights was taken here. The security interest is still created in a bundle of rights – which is actually nothing else than thing.

2.3 Creation and perfection of security interest

A creditor desiring to efficiently secure a loan by investment property must make sure that the security interest was effectively created and even if a dispute arises he will be satisfied before other creditors secured by the same collateral. Consequently, the creditor and the debtor undertake several steps referred to by Article 9 as attachment and perfection of the security interest.

From the moment of attachment, the creditor gains an enforceable security interest against the debtor, i.e. the debtor created right in collateral in favor of the creditor.[40] From the moment of perfection the secured creditor gains an enforceable security interest also against everyone else seeking to stake a claim in same collateral.[41] The purpose behind this differentiation unknown in other jurisdictions[42] is not easy to find even though we can see some rationale justifying prescribed steps: to eliminate secret lien public shall be put on notice which is not possible to achieve without a certain delay between the creation of a security agreement and notification of third parties achieved by any of perfection technique.[43] It seems that efficient alert to the public about creation of security interest is of special concern.

[40] *See* PHILIP R. WOOD, COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE (Sweet& Maxwell, 2007), at 7-001.
[41] *See* TAJTI, *supra note* 4, at 38.
[42] Roman-Germanic and countries which were influenced by Napoleonic code do not distinguish between attachment and perfection. *See* PHILIP R. WOOD, COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE (Sweet & Maxwell, 2007), at 7-002.
[43] *See* TAJTI, *supra note* 4, at 37.

2.3.1 Attachment

A security interest in investment property comes into existence, or in wording of Article 9 UCC, is "attached" if: (a) value has been given by the creditor (typically extension of credit); b) the debtor has rights in the collateral; (c) either security agreement was obtained or control of the collateral was established pursuant the contract or security certificate was delivered on the basis of the agreement.[44] For indirect holdings of securities it is important that "the attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account."[45]

2.3.2 Perfection

The essence of perfection is to notify the public that relevant personal property is subject to the security interest. If potential creditors are not notified that the debtor does not have full interest in particular piece of property they can be induced by ostensible ownership of the debtor and extend him a loan to their own harm. This would be as Gilmore observes against "one of the most firmly rooted doctrines of the common law [which] is the protection of creditors against undisclosed interests in property."[46] In other words, the creditors must be protected against secret liens in personal property not readily observable by them.

The danger of the secret lien was recognized in *Clow v. Woods*[47] where the Supreme Court of Pennsylvania affirmed the trial´s court judgment opinion that undisclosed security

[44] *See* SANDRA M ROCKS AND CARL S. BJERRE, THE ABC´S OF THE UCC. ARTICLE 8: INVESTMENT SECURITIES (American Bar Association, 1997), at 78-79 cited in JOHANSSON, *supra note* 7, at 143.
[45] *See* UCC s. 9-203(h).
[46] *See* GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (Little & Brown, Boston &Toronto, reprinted in 1999 by The Lawbook Exchange, Ltd. New Jersey), at 67.
[47] *See Clow and another v. Woods.* Supreme Court of Pennsylvania, western district, Pittsburgh, 5 Serg. & Rawle 275; Sept. 1819 Pa LEXIS 53. Mortgagor who was a tanner executed mortgage of the bark and tools in his tanyard and his skins and leather unfinished. The mortgage property remained in the possession of the mortgagor and secured creditors failed to record their security interest. After seizing and selling of property by sheriff based on judgment in favor of tanner´s former business partner, the secured creditors sued the sheriff in order to recover the proceeds of the sale.

interest establishes "fraud *per se*" because even without fraudulent view it could harm other creditors of the debtor relying on misleading impression about debtor´s property. Therefore secured creditors have a duty to "secure the public" against ostensible ownership of debtor.[48] *Clow* pronounced what became known as the problem of ostensible ownership when creditors induced by "false wealth" of the debtor extend credit to him.[49] The US quickly recognized the danger of the secret lien and concentrated on implementation of efficient mechanisms to protect the creditor.

2.3.2.1 Methods of perfection

UCC Article 9 defeated the secret lien by establishing several methods for putting the public on notice that the collateral is already subject to a security interest. Security interest in all kinds of investment property may be perfected by the filing of a financing statement with the relevant state office, control or in case of certificated security by the secured party´s taking delivery or automatically upon attachment.[50] Whereas filing represents the prevailing method of perfection for tangible collaterals a security interest in investment property is most often perfected by control. Preference of control relates to use of investment property in capital markets: banks, brokers and other security intermediaries engaged everyday in an enormous amount of secured financing transactions need simple and effective rules and cannot be subject to the burden of filing financial statements or searching the files.

Article 9 explains concept of control in uncertificated securities, certificated securities and securities entitlements by reference to essentially same conception in Article 8.[51] In

[48] *See Clow and another v. Woods.* Supreme Court of Pennsylvania, western district, Pittsburgh, 5 Serg. & Rawle 275; Sept. 1819 Pa LEXIS 53.
[49] *See* Jonathan C. Lipson, *Secret Liens: The end of Notice in Commercial Finance Law.* 21 Emory Bankr. Dev. J. 421, (2005), at 431.
[50] *See* UCC Part 3 "Perfection and Priority".
[51] *See* UCC s. 9-106(a). *See* STEPHEN L. SEPINUCK, PRACTICE UNDER ARTICLE 9 OF THE UCC (American Bar Association, 2008), at 43.

general, establishing control means that the secured creditor "has taken steps necessary to place itself in a position where he can have the securities sold without further cooperation of the debtor".[52] Irremissible steps depend on the form of investment property.

A security interest in certificated security in bearer form is established by control when the secured party takes delivery of the certificate.[53] A security interest in certificated security in registered form is perfected by delivery of certificate to the secured party who has its security either endorsed (or in blank) or registered in its name in the books of the issuer.[54]

If the security is not evidenced by a certificate perfection of control then it achieved by delivery or by entering into the control agreement according to which the issuer agrees to honor the instructions of the secured party rather than the registered owner´s instructions.[55] Despite existence of the secured party´s control the debtor need not to be prevented from disposing of its investment property carried in its securities account for purposes of managing and trading it.[56]

A secured party has control over the security entitlement, for purposes of perfecting a security interest, when it "either becomes the entitlement holder or has the bank, broker or other securities intermediary holding securities account agreed to follow its entitlement orders without further consent of the entitlement holder."[57]

In the indirect holding system the security interest is perfected automatically on attachment when created by the broker or other securities intermediary,[58] filing or establishing control has no effect on relationship between the parties. Furthermore, the securities

[52] *See* Official Comment 1 of the Uniform Commercial Code s. 8-106.
[53] *See* UCC s. 8-106(a).
[54] *See* UCC s. 8-106(b).
[55] *See* UCC s. 8-106(c).
[56] *See* HARRY C. SIGMAN, EVA-MARIA KIENINGER, CROSS-BORDER SECURITY OVER TANGIBLES: COMPARATIVE AND PRIVATE INTERNATIONAL LAW ISSUES (Sellier, 2007), at 41.
[57] *See* UCC s. 8-106(d).
[58] *See* UCC s. 9-309(10).

intermediary is protected in the default situation by creation of an automatic security interest in security entitlement after the security was credited to the investor´s security account.[59] The drafters presumed that the securities intermediary might be financing investors purchase and therefore shall rank first. Additionally, "perfection of a security interest in a securities account also perfects a security interest in the security entitlements carried in the securities account."[60]

It seems that the Article 9 provides effective perfection method tailored for every type of securities. The debtor still has the full right to deal with the security despite the secured creditor having control.

2.3.2.2 Is control tolerant to secret liens?

The core concern of perfection rules is to provide information to public that the property is secured and thus eliminate the secret lien problem. Nevertheless, with the introduction of control as perfection method for certain type of assets emerged new possibilities for secret liens. As argued by supporters of the superiority of filing over control the secured creditors obtain a security interest in the collateral that is neither discoverable from the public record nor readily observable because it is almost impossible to find out by third parties if the control agreement was concluded.[61] Moreover as Lipson[62] argues the development of forbearance to secret liens is based on a series of incomplete economic arguments.[63] However opponents to this type of reasoning are numerous. The justification of control as sufficient method for giving public notice about security rights in investment securities is argued by Schroeder based on pragmatic presumption of "general knowledge of

[59] *See* UCC s. 9-206.
[60] *See* UCC s. 9-308(f).
[61] *See* Lipson, *supra note* 49, at 462- 467.
[62] Jonathan C. Lipson is an Assistant Professor of Law at the University of Baltimore.
[63] *See* Lipson, *supra note* 49, at 474-516.

the lending industry" about probable security interest in securities accounts as it is practice in indirect system of securities holding.[64]

Secret liens are not enough to preclude control as perfection technique in special type of transactions mostly between professionals expecting simple, fast and certain rules. Pragmatic views prevailed although it seems contrary to requirement of public notice serving as awareness to others.

2.4 Priority rules

2.4.1 Control beats non-control

The secured party is not prevented from creating a security interest in the investment property collateral which possesses or over which has control for its own purposes.[65] Thus the secured creditor can repledge investment property but also the debtor can create security interest in the same investment property for benefit of other creditors. The question arises in case of default of the debtor who will be satisfied first because the investment property does not need to suffice for all secured creditors. This problem, unknown in the Czech law, is solved in US by priority rules.

A security interest perfected by control acquires priority over a conflicting security interest perfected by filing in the same investment property collateral even if control occurs after filing of financing statement.[66] The creditor is indeed permitted to perfect his security interest by filling but undertakes the risk that the debtor will grant a security interest in for instance, shares to third party who by taking delivery of properly indorsed certificates

[64] *See* Jeanne L. Schroeder, *Some Realism about Legal Surrealism,* 37 Wm and Mary L. Rev. 455 (1996), at 521-524.
[65] *See* JOHANSSON, *supra note* 7, at 145.
[66] *See* UCC s. 9-328(1).

achieves priority over him. The Common Law "first in time, first in right" rule is evidently suppressed by the Article 9 pragmatic priority rules ranking control as superior.

2.4.2 Priority of secured creditor over entitlement holder

As the superiority of control over filing under Article 9 seems reasonable the priority rules somehow controversially addressed the priority of secured creditor having control over the investment property over ultimate investor.

The indirect holding of securities on securities accounts where the intermediary mixes his securities with his clients' securities brings the risk that in case of intermediary's insolvency his creditors can reach against assets held by the intermediary for the benefit of investors.[67] This problem is known as the intermediary risk.[68] It is obvious that in the multi-tiered structure of interrelated brokers the failure of one link of chain can cause the failure of the others, i.e. systematic risk.[69] This problem is solved in the US because securities on account of the broker are not his "property" and the customer having proprietary rights is entitled to satisfy its claim before any general creditor.[70]

But the situation is not so clear with regard to certain secured creditors. Article 8 UCC protects security interest of secured creditors giving them priority over lower-tier entitlement holders (including ultimate investor) if the control was established.[71] That suggests that two interests stand against each other – proprietary and security.

[67] *See* Steven L.Schwarz, *Intermediary Risk in the Indirect Holding System for Securities*, 12 Duke J. Comp. & Int´l L. 309, at 309, 315.
[68] *See* Schwarz, *id.*, at 309.
[69] *See* Schwarz, *id.*, at 309.
[70] *See* YANNIS V. AVGERINOS, FINANCIAL MARKETS IN EUROPE: TOWARDS A SINGLE REGULATOR (Kluwer Law International, 2003), at 132-33, at 268.
[71] *See* JOHANSSON, *supra note* 7, at 144.

It seems that this controversy does not provoke much attention until it appears that the insolvent intermediary does not have sufficient assets to satisfy both secured creditor and entitlement holder. And here comes surprising solution of Article 8 - entitlement holder will loose against secured party having control.[72] This suggests that proprietary rights are subordinated to security interest given without the investor´s approval. Obvious unfairness seems to be justified by comprehensive legal framework on federal level[73] protecting investor´s property interests e.g. requirement of maintaining sufficient quantity of securities by intermediary, prohibition to grant security interest in client´s securities etc.[74] It seems though that with regard to systematic risk involved in multi-tiered holding system every justification of favoring secured creditor on expense of investors fails.[75]

2.5 Enforcement

Creation and perfection of security interest and priority rules all together compose basis for enforcement.

Remedies available to creditor under Article 9 UCC on default are repossession, disposition and strict foreclosure. Since establishment of control in investment property or delivery of certificated shares is far prevailing methods of perfection of security interest the repossession is not really an issue here.

[72] *See* UCC s. 8-511(b).
[73] *See* PHILIP R. WOOD, COMPARATIVE LAW OF SECURITY INTERESTS AND TITLE FINANCE (Sweet & Maxwell, 2007), at 15-080. Federal law prohibits intermediaries from using customers´ securities for their own purposes (e.g. create security interest), brokers are subject to requirement to hold sufficient securities to cover claims of all their clients. Brokers and dealers are under the Securities Investor Protection Act obliged to become members of the Securities Investor Protection Corporation which compensates clients of failed brokers with compensation for looses if brokers and dealers fail to held sufficient inventory of unencumbered assets. See Schwarz, *supra note* 67, *footnote note* 60. Under Rules 8c-1 and 15c2-1 promulgated by the Securities and Exchange Commission, a securities intermediary is prohibited from giving a security interest in customer securities without the customer´s consent.
[74] *See* ROGERS, *supra note* 26, at 268.
[75] *Contra* Russell A. Hakes, *U.C.C. Article 8: Will the Indirect Holding of Securities Survive the Light of Day*, LOYOLA LOS ANGELES LAW REVIEW 35 (2002) 661, at 725-26.

Whereas right to sell or otherwise dispose with the collateral in commercial manners is nothing surprising what is usually not available in jurisdictions outside US is strict foreclosure. The secured creditor keeps the collateral as his own in full satisfaction of the debt. As Gilmore puts it, it is „[t]he best and simplest way of liquidating any secured transaction".[76]

[76] *See* GILMORE, *supra note* 46, at 1220.

3. THE CZECH REPUBLIC

Whereas modern US security law has long tradition of fruitful development towards „successful systematization and corollary improvement of the previously anarchic field“[77] – Article 9 UCC, modern security law in the Czech Republic was practically non-existent until the last two decades.

I will demonstrate that by applying some of the pragmatism and creativeness of Article 9 such as the new approach to property rights in securities, the possibility to repledge securities, the concept of control or efficient enforcement methods, the Czech security law could create more creditor friendly environment attracting investors. I will also demonstrate that Czech law recognizes the special character of the financial market transactions and reacted by new rules on financial collateral substantially coming closer in line to Article 9 solution.

3.1 General remarks

After the fall of state command economy, security law was reintroduced to the Czech legal system by Civil Code[78] which was substantially revised by Act No. 367/2000 and Act No. 317/2001.[79] Czech law is based on civil law legal heritage influenced by the Austrian General Civil Code from 1811 (ABGB), recognizing traditional property law rules such as identification of assets in which property interest shall be created (”floating charge” is not recognized in Czech law) and the conception of security interest as right *in rem* maintained against everyone and deeply embedded with the asset.

[77] *See* TAJTI, *supra note* 4, at 19.
[78] Zákon č. 40/1964 Sb., občanský zákoník [Act No. 40/1964 Coll, as amended, Civil Code] of 26 February 1964.
[79] On history of Czech security law *see* Jan Kocina, *Zástavní právo v České Republice po poslední novelizaci, [Security Law in the Czech Republic after last revision]* Advocacy Bulletin 5/2002, at 20 - 32.

When building modern securities law framework the Czech legislator did not introduce anything similar to "Article 9 UCC", instead security law is fragmented in several statutes and secured transactions are dealt separately depending on the type of the collateral. In regards to securities, general (subsidiary) security law is placed in the Civil Code, the special complex regulation of securities exists in Securities Act[80] and rules for financial collateral regulation can be surprisingly found in ComC[81]. It appears that the non-existence of unitary regulation can cause the relationship of relevant laws to be ambiguous, and possibly needs some clarification in case law.

The Czech Republic successfully adopted a law permitting non-possessory security over movable assets alongside with a notification system.[82] Contrary to Article 9 UCC the number of security devices available are closed because the court will not enforce the agreement creating a new type of right. Therefore only a certain number of prescribed forms of security interests (e.g. pledge, security transfer andsecurity assignment) are available for the parties to the transaction. The position of secured creditors was enhanced by a new bankruptcy law which repealed previous regulation limiting secured creditors' satisfaction to a maximum of 70 percent of the claims. This short lasting experiment was repealed under a new Czech Insolvency Act No. 182/2006 Coll., as of 1st July 2007 so that secured creditors receive up to hundred percent of proceeds of the enforcement.[83]

[80] Zákon č. 591/1992 Sb., o cenných papírech [Act No. 591/1992 Coll., on Securities, as amended] of 20 November 1992.
[81] Zákon č. 513/1991 Sb., obchodní zákoník [Act No. 513/1991 Coll., the Commercial Code, as amended].
[82] *See* Kocina, *supra note* 79, at 25. The system of publicizing of non-possessory security by filing with register was introduced by amendment to Civil Code Act No. 317/2001. The register is maintained by the Czech Chamber of Notaries Public in electronic form, and permits the registration of a non-possessory lien through simple filing. The whole system was inspired by earlier Hungarian regulation.
[83] *See* Tomáš Richter, *One Flight over Czech Security Interests: Priorities and other Monsters of Post-Transformation Debtor/Creditor Law*, IES Occasional Paper 3/2006, IES FSV, Charles University, at 11-12.

3.2 Securities holding system

The structure of the Czech capital market is „rather fragmented and therefore ineffective"[84] and to analysis possible reasons and effects is beyond the scope of this thesis. If there is one fundamental deficiency that shall be pointed out, it would be non-existence of the central securities depository which would keep the register of the securities and in the same time provide the clearing and settlement of trades.[85] Instead, different bodies such as UNIVYC, a.s., RM-S, a.s. and Czech National Bank[86] provide clearing and settlement arrangements, whereas different entities[87] keep the register of securities and different institutions[88] execute cash settlement. As we can see, this rather confusing system of institutions predictably leads to unnecessary transactional costs, high operational risk and delays between securities and cash movements.

3.2.1 The Prague Securities Centre

Although the existence of the central depository is envisaged by the Capital Market Undertakings Act[89], for almost five years the conditions of its enforcement were not yet established. The factual necessity to have institution which will keep register of securities existing only as electronic records was in the Czech Republic addressed in a rather dissatisfied manners. Until the central register of securities maintained by the central

[84] *See The Report of the Czech Central Bank on Czech Financial Stability 2007*, at 44. http://www.cnb.cz/cs/financni_stabilita/zpravy_fs/fs_2007/FS_2007.pdf
[85] *See id.*, at 44.
[86] Settlement of the exchange trades as well as OTC transactions on the Czech capital market is mostly carried on by UNIVYC, a.s., the joint-stock company established as subsidiary of the Prague Stock Exchange. For further information see http://www.univyc.cz. RM-S, a.s. settles trades concluded in its OTC transactions (stock-off exchange trades). For further information see http://www.rmsystem.cz/. Czech National Bank provides clearing and settlement arrangements for short-term bonds deposited with it.
[87] The Prague Security Centre for domestic immaterialized securities, UNIVYC, a.s. keeps register of physical securities and foreign securities, Czech National Bank keeps register of government securities and short-term bonds.
[88] Cash settlement is executed by UNIVYC, a.s. through the mediation of the Clearing Centre of the Czech National Bank and by RM-S, a.s. through e.g. ČSOB, a.s. Settlement Trade Section.
[89] The Capital Market Undertakings Act also counts with establishment of separate register on investment instruments.

depository together with registers linked to it is established the function of it carries on the Prague Securities Centre[90] - the institution established for more efficient handling of mass amount of securities distributed in the voucher privatization.[91] The Centre maintains the unified register of all domestic dematerialized and immobilized securities existing only as book entries in register and of the owners thereof.[92] The Centre is a „kind of"[93] central depository implementing functions of envisaged central depository in a rather limited level due to the non-existence of the multi-tiered system.[94]

More than 90 percent of Czech securities are in a dematerialized form as the result of mass privatization in the 1990s.[95] The only other one permitable form of securities are certificated securities deposited with private depositories. Securities may be of the following types: (a) a bearer security, (b) a security to order or (c) a registered security (i.e. registered in someone's name).[96]

It appears that the Centre differs from the DTC in key aspects. It seems that the Centre does not hold securities in its accounts rather it only keeps the register of securities and of its owners. This is because the securities in dematerialized form does not "exist" without registration in the Centre´s accounts it seems that the register is in the same time also the register of the issuers. The claims of investors are not against the Centre but against the issuer.

[90] *See* s. 202 (1) a) of the Capital Market Undertakings Act.
[91] The Centre is the Czech state owned self-governing institution established December, 31 1992 by Ministry of Finance for voucher privatization carried on in the Czech Republic in 90th. *See* http://www.scp.cz. *See also* Vlastimil Pihera, *Nová právní úprava kapitálového trhu [New regulation of capital markets]*, Právní rozhledy 11/2004, at 413.
[92] *Principy ochrany zákaznického majetku, Konzultační materiál Komise pro cenné papíry, Komise pro cenné papíry, [The principles for protection of the client´s assets, Consultant material of the Securities Committee]*, KM 5/2003, sept. 2003, at 10.
[93] *See* Richter, *supra note* 83, at 22.
[94] *See Úřední sdělení České Národní Banky k povaze zápisu správce cenných papírů do evidence Střediska Cenných Papírů [Czech National Bank´s Communiqué About Nature of the Registration of securities depositor Registration in the Prague Securities Register]* dated Jan. 19, 2007, Bulletin ČNB, Volume 5/2007, at 2, *See also* Jan Dědič, *Zaknihované cenní papíry v současném českém právu [Dematerialized securities in the current Czech Law]*, Aplikované Právo 1/2006, at 29.
[95] *See* Depository Questionnaire 2008-2009 question 26a at http://www.scp.cz
[96] *See* s. 3 Securities Act.

The participants of the register are not only professional brokers or banks, but it also includes individuals. In other words, in the Czech Republic only direct holding system for securities exists.

3.2.2 Half step?

Because the implementing of the indirect holding system into the Czech Republic´s structure of capital market is not the subject of this thesis I would like to mention only possible deficiencies of current legal regulation of central depository compared with US securities holding system. Whereas the indirect holding system in the US is based on a multi-tiered pyramid of securities intermediaries that itself holds the interests in the securities through another intermediary, the Capital Market Undertakings Act counts with a different structure.[97] The central register of securities shall be maintained by the central depository and persons authorized to maintain a register linked to the central register of securities[98] (intermediaries) maintained by the central depository.[99] The law distinguishes between two kinds of accounts: client account and owner account.[100] Client account is account opened by an intermediary with a central depository. The intermediary in turn maintains an owner account linked to the central register of securities maintained by the central depository where he registers direct owner of the security.[101] Therefore we can come to a rather surprising

[97] Vlastimil Pihera, *Nová právní úprava kapitálového trhu [New regulation of capital market*s], Právní rozhledy 11/2004, at 414.

[98] *See* s. 92 (3) of the Capital Market Undertakings Act.

"A register linked to the central register of securities maintained by the central depository may be maintained by:

a) an investment firm whose license covers the investment service safekeeping and managing of investment instruments including related services ,

b) an investment company whose license covers the investment service safekeeping and managing of investment instruments including related services,

c) the Czech National Bank,

d) a foreign person whose objects of business correspond to the activities of the persons referred to in (a) and (b) above and that is authorized to provide investment services in the Czech Republic,

e) a foreign central depository or a foreign person authorized to maintain a register of investment instruments."

[99] *See* s. 92 (2) Capital Market Undertakings Act.

[100] *See* s. 94 (1) Capital Market Undertakings Act.

[101] *See* Pihera, *supra note* 97, at 414.

conclusion, that instead of a chain of intermediaries which we have experienced while explaining US indirect system we are dealing only with a two tier system – customer – intermediary and intermediary – central depository.[102]

It seems like half step was done towards a multi-tiered structure of intermediaries holding securities for their clients. The existence of a single institution holding securities for the benefit of its participants and performing clearance and settling function is common in almost all states with developed capital market.[103] Also, as far as I am aware, all Central and Eastern European countries already implemented indirect holding systems. If the Czech Republic wants to stay competitive it shall introduce a multi-tiered system applicable to both Czech and foreign investors. Hopefully, the implementation of a new system of central securities depository and registers linked to it will lead to a decrease of risk related to settlement and to a simplification of securities trades with lower costs and come closer to standard systems of indirect securities holdings. Above all, the investors are surely not interested in the holding of securities, but in rights and proceeds they receive based on those securities.

3.2.3 Character of the right

The current direct system of the securities holding and envisaged system of two-tiered holding are both based on the same fundamental idea. The intermediary does not have any property interest in securities hold on owner account (the full ownership remains with the investor) and the securities on client account shall be kept separately from intermediaries own assets.[104] Moreover, under the conception of the property interest requires identification of the asset. It follows that only designated entry in respect of specified securities renders a grant of

[102] *See id.,* at 413 - 414.
[103] *See id,* at 413.
[104] *See* s. 110 (3) of the Capital Market Undertakings Act.

the security interest so it cannot be granted in respect of a whole account as we have seen in the US. The Czech Republic's concept of the securities as "investor's property" is often subject to clarification by relevant authorities[105] or scholars.[106] The security interest cannot be granted in respect to whole accounts. That sufficiently slows down the process of the creation of pledge in securities.

3.3 Attachment and perfection of security interests

Czech legal theory distinguishes between two steps which must be taken to create the pledge - title and *modus*. If either the title or *modus* are missing the secured creditor does not have an enforceable pledge because the pledge is not created. [107] Similarly to the concept of attachment under the UCC, the title of the particular legal relationship of the parties is executed by a written agreement[108] which is enforceable only between the parties.

The manner in which Czech law deals with the problems of secret liens is rather inconsistent. Whereas the pledge in movables and immovables and incorporeal assets are subject to publication in registers, there is no such requirement for security transfer and security assignment.[109] It seems that similarly to the perfection in Article 9 the reason for the requirement of *modus* is to provide public notice, in particular to those who intend to extend a loan.[110]

Pledge in securities can be perfected in different ways depending on the type of the security. Whereas the pledge over certificated bearer securities is perfected by the delivery of

[105] *See Principy ochrany zákaznického majetku, Konzultační materiál Komise pro cenné papíry, Komise pro cenné papíry, [The principles for protection of the client´s assets, Consultant material of the Securities Committee]* KM 5/2003, Sept. 2003 (2003).
[106] *See* Vlastimil Pihera, *K některým aspektům majetkových práv k cenným papírům [On some aspects of the property rights to securities]*, Právník 1/2004.
[107] *See* Štefan Elek, *Vznik smluvního zástavního práva k movitým věcem [The creation of the contractual pledge over movables]*, Právní rozhledy 1/1999, at 1-2.
[108] *See* s. 39(1) the Securities Act in connection with s. 156 (1) the Civil Code.
[109] *See* Richter, *supra note* 83, at 5.
[110] *See* Elek, *supra note* 107,at 1-2.

the securities to the creditor[111], security interest in certificated registered securities requires an endorsement.[112] Pledge in certificated security that has been placed into safekeeping arises when the depository is notified about it.[113] It appears that such notification is in fact the "symbolic tradicio", i. e. delivery. "The pledge over book-entry securities will be perfected upon the registration of the pledge in the owner's securities account."[114]

If the articles of association demand approval of for instance, shareholder meeting for purposes of transfer of registered shares the security interest is perfected upon approval.[115] The pledge in book-entry securities will be registered with the Centre on the basis of an order made by a debtor, a pawner or a creditor. To avoid fraud the request must be accompanied by the original or by an officially authenticated copy of the pledge agreement.

It seems that registration of the security interest with the Centre is not the same as control because secured creditor is not entitled to dispose with securities in any manner. The Operational Rules[116] of the Centre strictly determine who is permitted to dispose with securities. Besides authorized public entities, investment firms on behalf of owner etc. only agents of owner based on the power of attorney issued by the owner is permitted to the disposal of securities.[117] In practice, the problem is „solved" by the power of attorney issued by the debtor for disposition with collateral. Moreover, the Centre requires a substantial amount of documents e.g. extracts from company registers which cannot be older than three months and apostilled powers of attorney. [118] This solution appears to be insufficient and with

[111] *See* s. 40 (1) Securities Act.
[112] *See* s. 40 (2) Securities Act.
[113] *See* s. 41 (2) Securities Act.
[114] *See* s. 42 (1) Securities Act.
[115] *See* Richter, *supra note* 83, at 22.
[116] *See* Operational Rules Art. 60 -67 „Security interest in securities registered with the centre" and Art.41 – 52 „ Administration of owners account".
[117] *See* Operational Rules Art. 49 (1).
[118] *See* Operational Rules Art. 47 (1) d).

regard to the essence of the security law unacceptable because the secured creditor does not practically possess any rights but merely acts on behalf of the debtor.

3.4 Priority rules

The owner of the collateral is entitled to dispose of the collateral nevertheless he is not entitled to repledge securities. According to the Securities Act any other subsequent *contractual* pledge may not be created in the same securities.[119] The debtor is therefore not entitled to grant security interest in securities and the creditor cannot repledge securities collateral.[120] Therefore, conflicting security interests are only the issue in insolvency i.e. the secured creditor prevails over general creditor.

I believe that the securities should be able to repledge because it offers more possibilities to secure loan and enhance credit provided that the clear and simple priority rules will be established as it is under Article 9.

3.5 Enforcement

In comparison with Article 9 UCC the enforcement possibilities of the Czech creditor secured by securities are rather limited. Nevertheless in comparison with possibilities given to general creditor (the court sale, sale by a judicial executor, sale in involuntary public auction) is quite broad.

On default the secured creditor is entitled to exercise the right to payment against the issuer and collect proceeds.[121] This way does not seem to be too effective and is unlikely to be used in practice. Another enforcement avenue is the sale of the pledged securities executed by

[119] *See* s. 39 (2) Securities Act.
[120] *See* JAN PAULY, KOMENTÁŘ JANA PAULYHO K ZÁKONU O CENNÝCH PAPÍRECH [The Commentary of Jan Pauly on the Securities Act] (Orac, 1998), at 148.
[121] Vlastimil Pihera, *K právní povaze zástavního práva k cenným papírům (antichrese v českém právu)[On legal nature of the pledge over securities (antichresis in Czech law)]*, Právní rozhledy 7/2004, at 262.

a licensed securities dealer after notification of a debtor in default.[122] It seems that if the debtor would now be notified the auction will still be valid in order to protect the good faith purchaser, but the secured creditor shall be responsible for potential damages caused.

The regulation in the Securities Act differs between the enforcement of the pledge over listed and over non-listed securities (i.e. shares that are admitted to trading on the regulated market, e.g. the Prague Stock Exchange). An investment firm sells the security on a regulated market on its own behalf, and on the account of the pledgor in the case of a listed security, or this sale shall be effected by the creditor in an out of court action in the case of a security that is not listed.[123] The apparent purpose is to sell it for a fair price. Thus, this is why we can also conclude that if the secured creditor is an investment firm it has to sell it through another investment firm and not by itself.

The question which arises is whether carrying a non-voluntary public auction[124] without any execution title, such as a court decision or notarial deed acknowledging existence of the claim is in compliance with constitutional principles.[125] This puzzle become an especially burning issue in light of the decision of the Constitutional Court which hold provision[126] which enabled involuntary public auction without execution title unconstitutional as „infringement of the principle of equality among subjects in same or similar position without existence of the objective and rational reasons for implementation of different

[122] *See* s. 44 (1) Securities Act.
[123] *See* s. 44 (2) Securities Act.
[124] *See* s. 33 (8) b) of the Capital Market Undertakings Act.
An involuntary public auction of securities may also be carried out:
a) if the petitioner proves that the owner of the security has defaulted on take-over, submission or hand-over of a physical security in spite of having been warned about a possible sale of the security in an auction, or
b) if a claim secured by a lien in respect of the security pursuant to a special legal rule governing securities has not been settled in a due and timely manner.
[125] *See* Petr Čech, *Zrušení § 36 (2) ZVD a zástavní právo k cenným papírům [Repeal of the s. 36 (2) Act on Public Auctions and Pledge over Securities]*, Právní zpravodaj 9/2005, (2005), at 5.
[126] *See* s. 36 (2) Zákon č. 26/2006 Sb., o veřejných dražbách [Act No. 26/2000, Coll., on Public Auctions]. This section was repealed by the Constitutional Court as of May 10, 2005.

approach."[127] As follows, the exception is constitutional if justifiable reasons exist. It appears that differential criteria follow from the nature of securities dealing carried on by professionals and subjected to commercial code which asks for lower level of protection of participants.[128]

The reason for the existence of securities is the disposal of the rights embodied into them, therefore the effort of the legislator shall be aimed at a flexible takeover of the collateral if default occurs. If the strict foreclosure will be introduced the practice of the Centre shall adapt and allow even secured creditors to dispose their securities on default for purposes of satisfaction of its claims.

3.6 Financial collateral

In the previous chapter I pointed out the most striking deficiencies of Czech law if securities are provided as collateral in the light of more advanced UCC Articles 8 and 9. In this chapter, I demonstrate that the Czech legal system implemented one security device which overcomes the highlighted deficiencies only to find itself to fail when confronted with practice. I will argue that by implementing the financial collateral the Czech security law deviated from familiar concepts, such as the traditional notion of *in rem* rights and *in personam* rights, and the prohibition of strict foreclosure or prohibition of repledge of securities in order to create a modern creditor friendly environment even though limited to transactions where financial collateral consists either of financial instruments[129] or cash. This preferential treatment is easily justifiable by the character of financial markets where market

[127] Decision of the Constitutional Court of the Czech Republic of 8 March 2005, on Auction of Collateral without Execution Title Pl.ÚS 47/04, N 47/36 SbNU 495, publicized in Collection of Law and Ordinances of the Czech Republic No. 181/2005, Coll.
[128] *See* Čech, *supra note* 125, at 6.
[129] According to s. 323a (2) c) ComC financial instruments are investment instruments (investment securities, collective investment securities, money market instruments and different kinds of derivatives) including claims and rights related to investment instruments.

participants reduce exposure to credit risk by providing securities as collateral and appropriate them on default.[130]

3.6.1 Implementation to Czech law

Contrary to the underlying policies of Article 9, it is clear that the impulse for implementation of financial collateral as for Czech Republic legal order rather revolutionary device was not a reaction to commercial practice but the duty to comply with legislation of the European Union. Financial collateral was put into place in Czech law by way of transposition[131] of the Financial Collateral Directive[132] adopted in the EU with the goal of achieving greater integration and cost-efficiency of a single financial market by introducing a uniform Community regime for use of the financial instruments and cash as collateral under both security interest and title transfer (outright transfer) structures.[133] Regulation of the title transfer financial collateral arrangement for securities purposes is not the subject of this thesis and neither is financial collateral consisting of cash. Thus, when talking about financial collateral what is meant is security interest in financial collateral consisting of securities dealt with on the capital markets.

The placement of new financial collateral rules within ComC drew attention to its relationship to other relevant norms. Financial collateral regulation should not be perceived as the introduction of a completely unknown security institute in Czech law, but rather as a

[130] See Vlastimil Pihera, *Finanční zajištění [Financial Collateral]*, Právní rozhledy 24/2005, (2005) at 902.
[131] Act No. 377 /2005 Coll., on supplementary supervision of banks, saving and credit co-operative associations, institutions of electronic money, insurance undertakings and investment firms in financial conglomerates and on amendment of some other acts via indirect amendment to the ComC (*see* s. 323a to 323f ComC) taking effect on Sept. 29, 2005.
[132] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.
[133] Preamble of the Financial Collateral Directive point 3, *available at* http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=32002L0047&model=guichett

modification of the security law well established in the Civil Code and with respect to securities in the Securities Act.[134] The potential collision[135] of laws is solved by the presumption that financial collateral provisions apply unless expressly stated in the security financial collateral arrangement.[136] In practice, the parties, if they can, of course rather invoke privileged treatment (e.g. in bankruptcy[137]) of financial collateral provisions.[138]

3.6.2 The scope of the financial collateral regulation

The financial collateral is closely related to the secured transactions carried on financial markets. Nevertheless since all legal persons[139] are eligible to enter into agreement on financial collateral, provided that the other party is a qualified subject (e.g., public authorities, financial institutions, investment firms) financial collateral is not only the concern of big financial market players. Secured can be claims of a financial nature arising from transactions involving monetary means or financial instruments.[140] An asset which is given as

[134] *See* Tomáš Sedláček, Lukáš Strnad, *Blíže smyslu finančního zajištění [Closer to Purpose of Financial Collateral]*, Právní rádce 02/2008, at 3, *available at* http://pravniradce.ihned.cz/c4-10077840-23003210-F00000_d-blize-smyslu-financniho-zajisteni.
Legal theory is inconsistent about application of subsidiary provisions of ComC or Securities Act. *See also* Tomáš Sedláček, Strnad Lukáš, Blíže smyslu finančního zajištění, právní rádce 02/2008, at 2-3 *and* Stanislav Plíva, *Finanční zajištění [Financial Collateral]*, Právní fórum 4/2006, at 124. *Compare to* Pihera, *supra note* 130, at 902.

[135] *See* Tomáš Sedláček, Lukáš Strnad, *Blíže smyslu finančního zajištění [Closer to Purpose of Financial Collateral]*, Právní rádce 02/2008, at 2-3. Original wording of the implementation of financial collateral regulation casted doubt if contractual relationship between qualified entities securing financial claims where securities served as collateral were subject to financial collateral regulation or if the parties can choose also general regime of Securities Act due to mandatory character of all sections regarding financial collateral.

[136] *See* s. 323a ComC.

[137] Newly adopted Act No. 182/2006, Coll., Insolvency act, effective as of January 1, 2008 in s. 366 (1) d) excludes financial collateral from insolvency proceedings.

[138] *See* Sedláček, Strnad, *supra note* 135, at 4.

[139] It shall be noted that in the original transposition, the Czech Republic partially used an opt out provision under the Financial Collateral Directive and implemented that financial collateral regulation applies only to undertakings of a certain size in terms of any two of the three criteria: assets, turnover and capital. *See Report from the Commission to the Council and the European Parliament. Evaluation report on the Financial Collateral Arrangements Directive* (2002/47/EC) dated 20 December 2006, at 8, *available at* http://ec.europa.eu/internal_market/financial-markets/docs/collateral/fcd_report_en.pdf

[140] *See* s. 323a (1) (a), s. 323a (2) (a) ComC.

a security can only be cash[141] or financial instruments. The typical transaction will probably be when the bank extends credit to an investment firm for the purchase of securities to expand its portfolio and bonds in investments firm´s ownership are provided as collateral.

3.6.3 The attachment and perfection of the security interest

Security interest attaches upon execution of the agreement which does not need to be in writing, nevertheless it should be evidenced in writing (electronic record etc.).[142] Security interest is perfected when securities were registered in books by the Centre or delivered to the creditor. With regard to dematerialized securities it is questionable if the current situation is in compliance with the Financial Collateral Directive requiring collateral to be under the control of the collateral taker[143] because the collateral taker is prevented from disposition with securities the same way as an ordinary creditor.

3.6.4 Right of use

What is novel in Czech law is the right of the collateral taker (secured creditor) to use financial collateral in accordance with the terms of the security financial collateral agreement.[144] If parties agree on the right of use clause, the collateral taker (and only him[145]) can use and dispose of securities which, of course, also implies the right to repledge or sell

[141] Surprisingly, the Czech Republic enhanced the list of the assets that might serve as collateral over the scope of Financial Collateral Directive by encompassing also credit claims. See *Report from the Commission to the Council and the European Parliament. Evaluation report on the Financial Collateral Arrangements Directive* (2002/47/EC), *supra note* 139, at 6.
[142] *See* s. 323a (9) ComC.
[143] Different opinion in Sedláček, Strnad, *supra note* 135, *footnote note* n. 22. On explanation of the conception of establishment control under the Financial Collateral Directive *see* Erica JOHANSSON, *supra note* 7, at 20.
[144] *See* s. 323b (2) ComC.
[145] *Contrary* Decision of Supreme Court of the Czech Republic of 16 July 2003, file no. 21 Cdo 296/2003 under the sanction of invalidity of such provision in contract promulgates that „security interest does not preclude owner of the collateral from disposition with collateral."

securities.[146] With regard to repledge it is the same as in UCC, which also allows the secured party (unless parties agreed otherwise) having possession or control to use debtor´s investment property to secure their own obligations even without approval from the debtor.[147] Suddenly, the secured creditor enjoys the same rights as the owner.

If the collateral receiver exercises the right of disposal, the secured interest in financial collateral is terminated and transferred to the liability of the financial collateral taker to replace the missing pledged securities by its equivalent.[148] And here again, if provided in the contract, the collateral taker can, instead of provision of securities, set off the value of the equivalent collateral against the claim of the security provider.[149] This is reminiscent of the security arrangement repos (sale and repurchase agreements) as we know them from US law.

But what happens from the legal point of view at the moment when the right of use is exercised and secured interest is terminated? The debtor´s right *in rem*, encompassing the right to have encumbered assets return upon satisfaction of obligation, is substituted by the right *in personam* to claim equivalent securities even though no default occurred.[150]

It seems that the danger here is that the position of the collateral provider is impaired because what if the collateral taker sells the securities but the claim is not enough to set off completely and the collateral taker becomes insolvent?[151] Maybe this is a rather high price for abandoning the traditional conception of contractual and personal rights in an effort "to reduce volatility and enable investors to buy or sell securities more easily at a fairer price."[152]

[146] *See* Pihera, *supra note* 130, at 903.
[147] *See* JOHANSSON, *supra note* 7, at 145, 184-85.
[148] *See* s. 323b (3), s. 323b (4) ComC.
[149] *See* s. 323b (5) ComC.
[150] *See* JOHANSSON, *supra note* 7, at 15.
[151] For possible solutions *see* JOHANSSON, *supra note* 7, at 184-188.
[152] European Commission, *Proposal for a Directive of the European Parliament and of the Council on Financial Collateral Arrangements* (27 March 2001) COM (2001) 168 final 2001/0086 (COD), at 4 to 6 cited in JOHANSSON, supra note 7, at 15.

3.6.5 Enforcement

On default, the financial collateral taker can sell securities in the customary manner on financial markets and settle the claim by keeping proceeds of the sale.[153] In comparison with the securities creditor, the collateral taker does not need to have securities sold by an investment firm on the regular market even if the collateral are public traded securities. In comparison with the creditor, he does not need to: notify the collateral provider, obtain approval of the court, or sell securities after a lapse of time etc.

The real innovation for the Czech legal system is the right of the collateral receiver (if previously agreed, including the method of assessment of securities value) to appropriate securities and set off the value against the secured obligation. Thus, the collateral taker becomes the owner of the securities and his claim against the collateral provider is discharged. This is familiar as the strict foreclosure was introduced in the Czech legal system.

3.6.6 Happy ending?

As we have seen above we have the right of the collateral taker to use securities including selling or repledging them, combined with a fast and simple solution on debtor´s default. What could go wrong? Even the best legislative regulation can be impaired by the factual situation of procedural implementation of rules. When the collateral taker decides to dispose with pledged securities based on the ”right of use” clause, he will clash with the technical and internal requirements of the Centre.[154] The Centre, pursuing its accustomed practice from the time when financial collateral was still a distant term, is not ready to follow collateral taker’s instructions, e.g. to pledge already pledged securities simply because he is

[153] *See* s. 323c (1) a) ComC.
[154] *See* Sedláček, Strnad, *supra note 135,* at 12.

not the owner of the account and is therefore entitled to dispose of the securities.[155] This casts doubts on the successful transposition of the Financial Collateral Directive on the Czech legal system and its application to dematerialized securities.[156]

De *lege ferenda*, the new established central depository shall pursue practice allowing collateral taker´s disposition with securities. For these purposes, the conception similar to control as found in Article 9 shall be introduced. The collateral taker shall be factually able to sell financial collateral without further intervention of debtor, e.g. without issuance of power of attorney.

[155] *See id.*, at 12.
[156] *See id.*, at 13.

4. CONCLUSION

This thesis showed that Article 9 UCC created creditor-friendly, simple and clear regime for secured transactions if investment property is collateral. The thesis demonstrated process of the creation, perfection, priority rules and enforcement of the security interest in investment property compared to the applicable rules in the Czech secured law. Moreover, the Articles 9 and 8 promptly reflected the changed nature of the securities held through a chain of brokers and banks in the form of electronic records. It provided a unique solution for problems regarding requirement for the identification of asset in order to create security interest. The thesis shows that by the introduction of the "securities entitlement" as the "bundle of rights" comprising personal rights as well as property rights of the entitlement holder, US secured transactions law uniquely solved the problem which could the Czech law experience in the future if the multi-tiered system of securities holdings will be introduced.

Is the US solution of applying the concept of security entitlement transferable to the Czech Republic? The multi-tiered system of securities holdings needs to be applied first. After the implementation of the indirect holding system the *sui generis* right comprising of property right and contractual right against intermediary shall be established. The new approach to the property interest in securities will have to be introduced but the justification can be easily found in special nature of the securities distinguishing them from other assets. Moreover, this thesis showed that the concept of the security entitlement under the Articles 8 and 9 UCC is better suited to the modern capital market practice.

As was discussed in this thesis despite numerous differences both systems share some common principles. The Czech secured transaction law came substantially closer to the more modern solutions of Articles 8 and 9 (possibility to re-pledge securities, strict foreclosure on debtor's default) when implemented special regulation for the financial collateral limited to use of the securities as collateral in capital markets transactions.

If one could have three wishes regarding pledge over securities under the Czech law it shall be implementation of efficient indirect holding system of securities enabling the creditor to have the securities sell without further action of the debtor in case of default. Second, the securities should be able to be repledged so the debtor and creditor can benefit from further enhancement of credit line while in the same time clear priority rules shall be introduced. Third, the creditor shall have possibility in case of the debtor's default to keep securities.

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