



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
SUBSTANTIVE RULES REGARDING INTERMEDIATED
SECURITIES
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***COMMENTS BY GOVERNMENTS
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(Comments by the Association of Global Custodians, AGC)

Purchase Money Security Interest and Priority

In today's securities markets, a securities intermediary may on occasion advance payment to settle a transaction on behalf of an account holder, and may credit the securities to the account holder's account before the account holder has actually made payment to the intermediary for those securities. This may occur for a variety of reasons, including timing issues relating to the crediting and debiting of accounts, when funds fail to materialize as forecasted, when an unrelated transaction fails to settle making anticipated funds unavailable, or most simply when a check or other form of payment used by the account holder takes several days to clear.

The preliminary draft Convention on Substantive Rules Regarding Intermediated Securities (March 2006 version) ("Convention") addresses many aspects of the activities involving intermediated securities, their acquisition, disposition and transfer, the security interests which may exist or be granted, and the priority among competing security interests. The draft Convention, however, does not address the fundamental issue of an account holder's rights in securities for which it has not yet paid; or put another way, a securities intermediary's rights relative to securities with respect to which it has advanced payment.

As currently drafted, Article 5, paragraph 7 of the Convention provides that the domestic non-Convention law determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties. While this is doubtless a helpful step in the right direction, it would be incongruous if the draft Convention were to so deftly set out the circumstances and mechanics under which security interests may be granted by an account holder to third parties, and the priorities which those security interests enjoy, but were to fail to address the primordial situation where the account holder has had securities credited to its account but has not yet paid the intermediary.

Indeed, it could undermine the effort to create financial and legal certainty if an account holder could grant priority security interests to third parties with respect to securities for which the account holder had not yet made payment.

Accordingly, we recommend that the draft Convention expressly provide for the automatic creation of a “purchase money security interest” in favor of an intermediary that advances funds to pay for securities which have been credited to an account holder’s account. It is critical that this security interest arise and be perfected automatically, without requiring any steps to be taken by the intermediary, and that the security interest have first priority. This security interest would, in the vast majority of cases, be very short-lived, and would automatically be extinguished upon actual payment. Because of the temporal nature of the security interest, it would in practice almost never conflict with the account holder’s rights or rights granted to third parties. The existence of an automatic “purchase money security interest” would also avoid the need for any construct that the securities had “not really” or only “provisionally” been credited to the account, pending payment.

An express “purchase money security interest” in the draft Convention is thus an essential step in protecting the efficiency, liquidity and integrity of the financial markets, and the interests of securities intermediaries, account holders, collateral takers and third parties alike.

In the United States, the Uniform Commercial Code recognizes that securities intermediaries may treat the entitlement holder as entitled to financial assets before the entitlement holder has actually made payment. In such circumstances, Sections 9-206(a) and (b) give the intermediary an automatic security interest in the entitlement holder’s security entitlement. This provision, and others that may similarly exist in the domestic non-Convention law of other jurisdictions protect custodians and other securities intermediaries, but would not cover cross-border transactions in instances where the entitlement holder’s securities account(s) are maintained in jurisdictions that do not have a similar non-Convention law.

Consideration will need to be given to whether other provisions of the Convention may need conforming changes, but we strongly recommend revising the text Article 5 to include the following provision:

“When securities are credited by an intermediary to the securities account of an account holder in accordance with Article 4.1, an intermediary that has advanced payment for such securities shall have an automatic first priority security interest in the securities against the account holder and against third parties until actual payment has been made by the account holder.”

The adoption of such a provision within the Convention would provide greater certainty and protection for securities intermediaries, account holders and collateral takers alike. It would promote uniformity and predictability in the application of the convention, and contribute to the efficiency and liquidity in the settlement transaction process. By creating an automatic level of protection for intermediaries, it would also contribute to the safety and soundness of the financial system.