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Theoretical and Legal Reflections on Securities Dispositions

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Abstract

Decreasing the number of materialised securities for the benefit of electronic securities has led to distinctions between commercial and legal opinions on securities transactions. Contemporary financial markets only trade electronic securities held in securities accounts. Securities law enhances adjustments to economic realities and not to legal principles. Discrepancies between economic realities and securities regulation should be resolved in order to find a balance between successfully functioning transactions of electronic securities and legal schemes which are based on transfers of physically existing assets, which include securities, as a result of the theory of incorporations, in certain legal regulations. This article is a theoretical and legal reflection on selected issues connected with the transfer of securities with reference to discrepancies between economic realities and legal regulations.

Key words

Securities, dematerialised securities, legal regulation, economic realities, securities dispositions, legal order

JEL Classification: K39

Introduction

The main reason and benefit for investors to be interested in securities is the implementation of authorizations for securities dispositions. Legal order ensures the implementation of authorisations for securities dispositions. Dematerialised securities dispositions are realised through the changes of entries in the securities accounts, i.e. through crediting and debiting securities to accounts of their respective owners. Transfers of securities are mostly run parallel with the transfers of funds which are prices at which securities are transferred. Other securities may also be regarded as counter value for the transferred securities. This technical operation can be incorporated in various kinds of legal regulations. This may include the purchase or sale of securities, acquisition of securities, custody and management of securities, collateralised liabilities, securities lending or the repurchase of securities. The purpose of securities disposition may be a speculative definitive transfer of property rights or the transfer of other rights to dispose of securities for profit, or it may have security features when the disposition of securities serves as collateral for the fulfilment of other obligations. Besides the right to dispose of securities there is a right to hold securities, ius possidendi. If securities are dematerialised, their holding is not possible, because there is no eligible

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subject of possession. The right to use and utilise securities, ius utendi et fruendi, is one of the greatest problems of securities. The securities law only rarely allows for the property rights in the use of securities. It may be e.g. the right of a shareholder to participate in the management of a joint stock company through participation in the general meeting. But in most cases, this right is manifested in the form of securities disposition so that the right to use and utilise securities is mostly absorbed by the right to dispose of securities.

1 Methodology

The article uses socio-scientific, and theoretical approaches and applies general scientific methods of analysis and synthesis, induction and deduction, abstraction, benchmarking and the method of generalisation. Philosophical methods of perception are utilised in the generalisation of specific problems. The method of scientific abstraction is used to distinguish the irrelevant and accidental from the substantial and regular. The article is a theoretical and legal reflection on selected issues connected with the transfer of securities with reference to discrepancies between economic realities and legal regulations.

2 Results and Discussion

Financial market transactions are mainly executed electronically in the 21st century. The volume of daily electronic securities transactions, including hedging transactions of OECD countries, has exceeded the volume of global gross domestic product (about 36 billion USD at the time)[3] every 20 days of trading in financial markets. Contemporary financial markets only trade in electronic, fully dematerialized securities that are held in securities accounts. Materialised securities transactions are no longer executed on the financial markets in advanced economies.

It is evident from an economic perspective that electronic securities transactions generate less costs and greater profits than materialised securities transactions. Thanks to computerisation, it is possible to deal, in an incomparably shorter time, with a much higher volume and complexity of transactions that are carried out daily on the financial markets. Since these transactions do not involve any physical delivery or transfer of securities, the risk of loss, theft or counterfeiting of the securities is completely eliminated, thus electronic transactions substantially reduce the costs to protect the security and transfer of securities. Electronic transactions also provide the possibility of continuous trading in securities, because their trading process is not stopped in a manner typical for materialised securities.

[3] Commentary on the Hague Securities Convention concluded on July, 5, 2006 on Certain Rights in Respect of Securities Held with an Intermediary, p. 4.

2.1 Economic Realities versus Legal Regulations

A different perception is utilised in the transfer of securities by traders and lawyers. When traders in securities transfer an economic value in electronic records, lawyers refer to transfers of movable assets represented by securities. Even though traders mainly trade in electronic securities, lawyers still refer to categories of directly held materialised securities.

At first glance and without any deeper analysis securities should be categorised as tangible assets. Historically securities were regarded as papers which were assets. As long as securities are considered as assets, the relationship between the owner and the securities is seen as ownership.

Dematerialised securities with no material substance are perceived as problematic, since they are electronic records which do not meet the conditions necessary for assets to represent property rights.

The hypothesis that securities, either materialised or dematerialised, are regarded as tangible assets is widely acknowledged both in legal doctrine and practice (Brzobohatý, 1998; Švestka & Škárová, 2003). Legal theory also supports the opinion that securities belong to the category of other property assets. Based on this view, securities represent rights incorporated in tangible substrates, thus securities cannot be referred to as assets, since single securities are only bearers of substantive rights (Dědič & Pauly, 1994). The usefulness of securities is not in the paper itself, but in the rights embodied in it. The same applies for dematerialised securities, however, they are more complicated because the bearer is regarded as a material substrate in which securities are dematerialised, i.e. recorded. Printed reproductions of this electronic information (statements of securities accounts) are not securities. Dematerialised securities are not assets that exist objectively in the real world, but they are legally created concepts which exist under the law.[4]

The French law considers dematerialised securities as movable assets; the German law regards them as a specific abstract property-aggregate using the rule of disposal of these assets; the Swiss law considers dematerialised securities as subjects to legal relations of a special kind with a particular form of property rights; the English law considers dematerialised securities both as liabilities and intangible assets.

In terms of private law, the classification of securities is not clearly resolved in the Slovak jurisprudence. The classification of securities into certain categories of civil relations determines a specific mode of their disposition, and this may stimulate or impede economic transactions and processes. The features of the civil relations are cumulative: human manageability, social usefulness, proprietorial nature or valuables-consideration in monetary terms, and capability for private dispositions, i.e. the given subject is not an asset excluded from the scope of private law. A negative constitutive attribute should be assigned to a positive constitutive feature, which should indicate

[4] "In a transparent system of direct property rights electronic securities will be considered as assets, whereas the rights to them will have an effect of erga omnes and the rights associated with them will be performed directly by the final owner of the account, while in non-transparent systems of multi-layered provisions electronic securities will be closer to receivables while the rights to them will have an impact only on the depositary and the rights associated with them will usually be performed by the depositary." (Vondráček, 2013, p.58)

distinguishability and independent existence in the subject of the law, i.e. no subject is an inalienable part of a person and is capable of independent existence. Securities are subjects which are manageable by human beings, provide social benefits, are measurable in monetary terms and are not a matter beyond the scope of private law. In terms of the negative constitutive attribute of civil relations, i.e. distinguishability, and independent existence in the subject of the law, this attribute should be fulfilled by materialised securities. Dematerialised securities do not meet the criterion of distinguishability, because they cannot exist independently of the person who conducts the appropriate registration of securities. Nevertheless, it is possible to regard dematerialised securities as subjects of civil relations which can exist independently of the depositary entity and which can be identified through a securities account maintained by the central depository for the account holder. Thus, it can be concluded that securities, both materialised and dematerialised, are eligible subjects to civil relations. The most general definition of the subject of private relations is contained in § 118 Article 1 of the Civil Code, according to which they are the subject of civil relations, and rights or other assets. Therefore, it is important to find out to which categories of civil relations securities belong. Should they be considered as subjects to law or as property interests?

Jurisprudence assigns securities to other property asset. Pursuant to § 9 Article 2 of the Securities Act, securities are subject to the provisions of the Civil Code of tangible assets, unless stipulated otherwise by the Securities Act or a special law. The legal definition of securities indicates that the legislator regards securities as tangible assets, and that securities are subject to property rights, just like movables. The legislative intent of the recodification of private law in the Slovak Republic indicates that securities will be included among the subjects of property rights and they will have a property rule of movables. Legal protection of property rights of a person to securities and his legal relationship to them are built on the same level as the property rights to the subject.[5] According to this legal definition the right to securities is objective and absolute, and is governed by the Civil Code, unless stipulated otherwise by the Securities Act or a special law. The subject of property rights to securities is to hold, use and gain, thus it is identical with the character and subject of property rights.

In the past there was a clear similarity between business and legal realities, mainly due to the theory of rights incorporation in materialised securities and the transfer of these rights together with the securities, whereas a gradual reduction in the number of materialised securities in favour of electronic securities has resulted in discrepancies between business and legal opinions on securities transactions since the late 20th century (Vondráček, 2013). On the one hand, it is a natural characteristic of law that it is slower in the reflection of real changes than economics or business practices on financial markets, on the other hand, there is an evident attempt by lawyers to change the old concepts so that they could reflect financial market realities. Discrepancies between economic realities and securities regulations should be resolved in order to find a balance between the successfully functioning models of transactions of electronic securities and legal schemes based on physical transfers which, based on the theory of incorporations, involve securities.

[5] According Žitňanská and Ovečková (2009, p. 593) such an attitude of the legislator should be viewed critically, because doctrine in a historical context does not refer to securities as movable property. The essence of securities lies in the incorporation of rights in tangibles.

2.2 Securities Dispositions

The purpose of transfers of electronic securities is always financial and focuses on the increase in the value of the securities. The purpose of the transfer of securities is never based on consumption, because securities cannot directly satisfy any human need. This difference of securities from other goods is also reflected in their legal regulations, however goods that can satisfy any need (e.g. foodstuff) emphasise the importance of their physical transfer to buyers in a shop, because this is the only way to utilise their value by the buyer. Securities obtained for investment purposes do not stress the necessity of their physical transfer to the acquirer. This has a major impact on the real nature of contracts on the transfer of electronic securities.

Transfers of electronic securities differ from transfers of actually existing assets, including materialised securities because their transfer does not require the delivery of any material asset. Physically existing materialised securities have been converted into electronic securities which are electronically recorded in the records of central depositories. To conclude financial market transactions there is a need to record changes in electronically managed securities accounts. There is no physical transfer of securities or cash.

The subject of transfers of dematerialised securities is the right to dispose of securities classified differently by legal regulations, e.g. property rights[6], sui generis[7], and property interest[8]. The direct subject of the transfer is not the object of this law, i.e. dematerialised securities, but the right connected to securities. Changes in the property rights of movables, with some exceptions, are not necessary to register in any special register. This further distinguishes the electronic transfers of securities from the transfer of tangible assets, including materialised securities, because each change in the property rights of electronic securities requires registration in the register of the Central Depository. This makes the transfer of electronic securities similar to the transfers of immovable assets, since there is no physical transfer of assets between the transferor and the acquirer, but the transfer is realised through changes in the records, through a deposit in the real estate register. The difference results from the character of the register, since real estate registers provide publicly accessible records, which are ensured by the state, even though registers of electronic securities are regulated publicly by the state, they are managed by depositors that are private businesses. This difference is based on the fact that immovable assets belong to the territory of a state, whereas private businesses and their shares have no direct connections with the state. This difference between public records of immovable assets and the private records of electronic securities does not affect the fact that the transfers of electronic securities are by nature closer to the transfers of immovable assets than to the transfers of movables.

[6] The account holder of securities by the French law is described as the owner. Art. L. 211-4, first sentence of the French Monetary and Financial Code (Code monétaire et financier - CMF) and Art. L. 211-17 CMF.

[7] In the Belgian and Luxembourgian law dematerialised securities are tenants in common, or material rights of intangible nature to the total of fungible securities and financial instruments. A person who has the rights mentioned in the Belgian law refers to as a co-owner siu generis. The Luxembourgian law has been identified as beneficiary of substantive law sui generis.

[8] Property interest - § 8-503b) Uniform American Commercial Code

Transfers of dematerialised securities take place in the context of securities trading. The concept of trading in securities can be understood in a narrow and broad sense. In a broader sense, this term refers to the exchange of property for other assets or for cash. On capital markets it is associated with trading in securities on the secondary market, on which the holders of securities sell these securities to other holders of securities.[9] In a narrow sense trading in securities means trading on a regulated public stock exchange.

Any transaction aimed at the transfer of property or other rights with the attempt to dispose of securities is realised in two stages. In the first phase there is an agreement between the transferor and the acquirer, and in the second phase this agreement is implemented by the transfer of the agreed number of securities from the account of the transferor to the account of the acquirer, or through the payment of the purchase price for the securities by the acquirer to the account of the transferor. The transfer of securities on and out of regulated markets is realised in similar phases. The transfer of securities can be performed either through direct transfers between individuals or through complex transfers which take place through market infrastructures and settlement systems.

Technically, the transfer of dematerialised securities is realised through changes in the records of the transferor's securities account – debiting securities from the account and making changes in the records of the acquirer's securities account – crediting securities to the account. Simultaneously with the implementation of the records on the securities accounts of the transferor and acquirer, an opposite operation shall be carried out on their cash accounts, i.e. crediting funds to a bank account of the transferor of securities and writing off funds from the acquirer's securities account. The basic method for the transfer of dematerialised securities is a change in the records of the accounts of the transferor and acquirer, i.e. writing off securities from the account of the transferor and crediting them to the account of the acquirer. The transfer to third parties gains effort when securities are credited to the account of the acquirer, or it may be the moment of crediting funds that represent the purchase price to a relevant cash account.

The securities account, which is a set of electronic records stored in a computer memory, represents the basic existential conditions for dematerialised securities. Its basic function is to record securities and their owners. The securities account cannot be regarded in legal terms, which would be the subject-matter, for example, of property rights, because it is not a tangible asset. Nevertheless, it is an object that is perceptible by the senses, which can be controlled by human beings, and which has its economic benefits. The fact that a person is the holder of the securities account does not automatically mean that he is the holders of securities, which are recorded in this account. Within the system of direct ownership which is applied in the Slovak Republic, the holder of the securities registered in the accounts of physical or legal entities, is a person registered as the account holder at the last depository in the ownership structure. That person may also be the depositary himself, if he is the final owner of the securities. The depository that manages a securities account for others, is not, in this

[9] A primary market is a market which refers to a process of underwriting in which newly issued securities are transferred from the issuer to the first owner. In the secondary market the securities are traded through a regulated public stock exchange or other organised system, or the OTC on freely accessible markets.

system, a holder of securities which are registered in a securities account. In the Anglo-Saxon legal systems (e.g. England, Ireland, Cyprus, and Malta) the owner of the securities account, in relation to the securities recorded in this account, has an economic status of ownership. In relation to other owners who have their securities registered at the same depositary, the holder of securities account is an equitable tenant in common status. The economic ownership of the account holder is regarded as a proprietary interest. In the English law, the legal owner of dematerialised securities is the depositary at the highest level of the property structure. This depository holds securities for a beneficiary within the frame of a trust. A beneficiary can either be the final owner of the account or another depository who manages these securities in a trust for other beneficiaries.

2.3 The New Czech Legislation

In accordance with the new legislation, under § 489 et seq. New Czech Civil Code, Act No.89/2012 Coll. (New Czech Civil Code), securities are assets in a legal sense. An asset is anything that is different from the person and which serves the needs of people. Simultaneously, pursuant to § 498 Article 2, the rights attached to securities are movable assets, because all the assets, except for immovable assets, whether tangible or intangible, are regarded as movables and are immaterial under § 496 because intangible assets are rights by nature and are assets without material substance. As long as the rights (the assets in a legal sense) are embedded in the securities, under this legislation, and in compliance with other conditions, they refer to securities. Securities similarly to unincorporated rights are also assets. Due to the physical nature of securities, they refer to tangible assets under § 496. On the other hand, dematerialised securities, which do not exist physically, are not securities, they are intangible assets.

The New Czech Civil Code excludes two types of securities on the basis of their form, i.e. materialised and dematerialised securities. The provisions of § 514 assign the legal nature of securities only to materialised securities.[10] If the rights are not embedded in the securities, then they cannot be regarded as securities. This right should be clearly visible in the securities, and not in the contract under which the securities have been issued.

In legal terms, securities should physically exist. The type and form of the material from which securities are made is not governed by law. However, the permanent storage of the written text of intentions and transferability should be ensured by the quality of the issued material. The owner of the tangible material, which includes the rights, should not be able to apply the rights without the securities.

The New Czech Civil Code has brought about a significant change in the definition of dematerialised securities. Before the adoption of the new Czech Civil Code, dematerialised securities were regarded as securities. Securities replaced by dematerialised securities are regulated by § 525 Article 1 of the New Czech Civil Code: "If securities are replaced by an entry in the relevant register and can only be transferred by chang-

[10] Pursuant to § 514 of the New Czech Civil Code: "Securities are charters with which the rights are assigned in such a way that after the issuance of securities it is not possible to use or transfer securities without this paper."

ing the entry in the register, then they are considered as dematerialised securities. Dematerialised securities are fungible if they are issued by the same issuer and if they arise from the same rights." This definition of dematerialised securities is based on the primary existence of securities which can be "replaced" by an entry in the register, i.e. as if they were substitutes for securities.[11] The reason for substituting securities with dematerialised securities is not clear. Dematerialised securities are therefore not referred to as securities, since securities are rights embodied only in the paper. Dematerialised securities do not have a material value, which makes them different from most securities. They are not, in terms of this modification, securities by form, but rights which comply with the provisions of securities (rights which replace securities).

Materialised securities and dematerialised securities differ from each other in many ways, e.g. in different modes of creation, transfer or the application of the rights embodied. Nevertheless, under the provisions of 525 article 2 New Czech Civil Code, dematerialised securities are described by the provisions of securities, unless stipulated otherwise by their nature or by law. Dematerialised securities, pursuant to § 489 New Czech Legal Code, are considered as assets in a legal sense. The Czech legal system allows the dematerialisation of most rights. It is possible to dematerialise shares, separately transferable rights attached to shares, convertible and priority bonds, warrants, share certificates. But it is not true that securities must be replaceable by entries in the register, and not all securities can thus be replaced and issued as dematerialised securities.

The existence of terms such as materialised securities and dematerialised securities as substitutes for securities under the Czech legislation is unfortunate. The reason for replacing securities with dematerialised securities is not obvious in this legal regulation, probably it is still related to the development of securities at a time when only tangible assets were perceived as securities. Dematerialised securities do not arise as a substitute for securities, their creation lies in the entry of the issues of dematerialised securities in the register. The good thing about this arrangement is that in addition to the new definition of securities, dematerialised securities have also been defined, whose definition lacked in the Czech legislation.

Conclusion

The financial market is characterised by constant development and is enriched by new types and categories of securities which are offered to investors in large volumes. The modern system of law should accept the realities of the 21st century, since the number of transactions concluded on the financial markets with an infinite number of certificated securities repeatedly exceeds transactions in tangible assets.

The development of securities law focuses on adjustments to economic realities and not to legal principles. Therefore, the existing system of indirectly possessed elec-

[11] The explanatory report on the new Civil Code claims that "the modern adaptations of dematerialized securities in 2010 in Switzerland and Germany recommended the elimination of the concept of two forms of securities. The proposed definition of securities combines securities with papers. A paper is a defining element of securities. Dematerialised securities will no longer be defined as securities. This approach is sensible since dematerialised securities will not be distinguished by form, the Act should regulate the special way of their transfer or suspension."

tronic securities needs to be adapted to the legal status of economic realities, e.g. through the example of UNIDROIT Geneva Convention of 2009 on substantive provisions related to electronic securities which form the basis of the new Swiss law on electronic securities, which entered into force on January, 1, 2010. New legal concepts which take into account the reality of digitalized financial markets provide greater legal certainty for the entire financial market.

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